



CONSTRUCTION LAW UPDATE No. 806

Calling on the guarantee

Introduction

A recent decision of the Federal Court of Australia deals with the right of the owner to call upon a US\$21m bank guarantee provided by the builder under a construction contract (*Clough Engineering Limited v Oil and Natural Gas Corporation Limited* [2008] FCAFC 136).

Background

In many commercial construction contracts, the builder is required to provide to the owner some form of financial guarantee that the work will be brought to practical completion and that any defects will be rectified within the defect liability period following practical completion. The guarantee is often provided in the form of an unconditional guarantee from a bank. If the builder defaults under the contract, the owner is entitled to call on the guarantee and obtain a cash amount from the bank.

The facts

Clough Engineering Limited (“Clough”), an Australian company, entered into a lump sum contract with Oil and Natural Gas Corporation Limited (“ONGC”) for US\$215m to develop oil and gas fields in India. Under the contract, Clough was to supply and construct a functioning oil well platform, pipelines, control systems, pumping systems and a processing facility.

Clough was required to provide an irrevocable bank guarantee in the amount of US\$21m, being 10% of the contract price.

Disputes arose between Clough and ONGC over extensions of time for the works and in relation to the insurance requirements for the works. On 4 June 2007, ONGC terminated the contract with Clough and on the same day, called on the bank guarantee.

Clough immediately took legal action seeking to stop ONGC and the banks from paying out

the US\$21m. In the absence of the other parties, the Court granted to Clough an interim injunction restraining the payment to ONGC.

When the matter came before the Federal Court for full argument with all parties represented, the Court refused to continue the interim injunction. The Court said that the guarantee was able to be called on by ONGC, and said that it would not restrain the banks from paying out the funds.

Clough then applied for a stay on the payment pending an appeal to the Full Court of the Federal Court. The Court granted the stay. This update relates to the outcome of the appeal.

The competing views

Clough submitted that ONGC was not entitled to call on the guarantee because Clough was not in actual breach of its contractual obligations.

Clough said that ONGC only had the right under the contract to call on the guarantees “*in the event of [Clough] failing to honour any of the commitments entered into under this contract*”. Clough said that it had not failed to honour its commitments under the contract and therefore ONGC was not entitled to call on the guarantees. Clough said that a mere claim by ONGC that Clough was in breach of the contract was not sufficient.

Clough also claimed that the call on the guarantee was unconscionable. Clough sought relief under the s51AA of the *Trade Practices Act 1974* preventing payment of the US\$21m.

For its part, ONGC said that the right to call on the guarantees was not restricted as claimed by Clough. It said that it did not matter whether actual breaches of the contract were established, all ONGC had to do was to make a bona fide claim of a failure by Clough to “honour” its “commitments” under the contract and it was then entitled to call on the guarantee.

In any event, said ONGC, Clough had breached the contract by failing to extend the expiry date of the bank guarantees to match the extended duration of the contract. ONGC said that Clough had also breached the contract by failing to provide certificates of currency in relation to its insurance.

The Court's reasoning

The Court reviewed the longstanding authorities in this area and in particular referred to *Wood Hall v The Pipeline Authority*. The Court said that to introduce a qualification on the entitlement of the owner to call upon guarantees would be to deprive them of the quality which gives them commercial currency.

However the Court noted that there remain three exceptions where a court may prevent the issuer of the guarantee from making the payment. The three exceptions are:

- where the claim on the guarantee is fraudulently made;
- where the claim on the guarantee is unconscionably made;
- where the contract terms limit the right to call upon the guarantee.

The Court considered that only the last of these three exceptions had any potential relevance to Clough's claims. The Court referred to this exception as more of an "over-riding rule". However, the Court concluded that:

"clear words will be required to support a construction which inhibits a beneficiary from calling on a performance guarantee where a breach is alleged in good faith, ie, non-fraudulently."

In other words, there is a presumption that an unconditional guarantee is indeed unconditional. In assessing the contract, the Court said it needed to have regard also to the terms of the guarantee as the terms of a contract must be read as a whole. In this instance, the guarantee included the words that payment could be made "notwithstanding any disputes pending". Here, the guarantee envisaged a situation where Clough and ONGC were in dispute and accordingly provided for a situation where ONGC claimed that Clough had breached the contract and Clough asserted that it had not done so.

In any event, the Court found that Clough had failed to deliver certificates of insurance and had failed to extend the expiry dates of the

guarantees, both technical breaches of the contract. These findings precluded the possibility of unconscionable conduct by ONGC. Accordingly, the Court allowed ONGC to call upon the guarantee and allowed the banks to pay out the guaranteed sum.

Conclusion

The law in this area remains unchanged. Performance guarantees are virtually blank cheques in the hand of the owner unless there are clear words in the contract and the guarantee that restrict the right of the holder to call upon the guarantee.

The right to obtain the cash through a guarantee does not create an entitlement to retain the cash. Ultimately, a dispute as to the merits of the claim may result in the return of the funds. However, as a cash flow issue, bank guarantees must be considered as vulnerable to any claim by the holder of the guarantee that cannot be shown to be fraudulent or unconscionable.

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