The Legal Operation of the Unconditional Performance Guarantee

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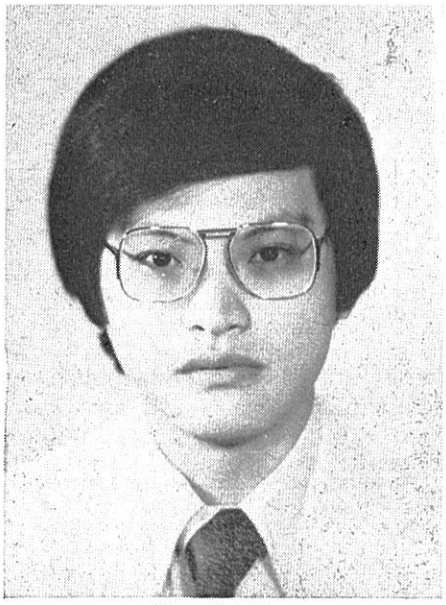
The so called "unconditional performance guarantee" is such a common creature in construction contracts these days that recent development of the law in this area must serve more than as objects of passing interest to many contractors and their consultants. What has perhaps generated considerable uproar in the course of this development, particularly at a time when political instability and uncertainty seem to pervade those parts of the globe which attract the major share of construction activity, is the extent to which courts in common law jurisdictions, notably England and Australia, are prepared to go in giving these performance guarantees their unfettered effect.

The principles on the subject were discussed at great length by Lord Denning, MR in the case of *Edward Owen Engineering Limited* v *Barclays Bank International*,[1] heard before the English Court of Appeal. In November 1976, Edward Owen Engineering negotiated for a contract with the Agricultural Development Council of Libya under which Edward Owen was to supply and install glasshouses for their Libyan customers. The glasshouses were to cover an area of approximately five acres and were to be equipped with a complete irrigation system. The total contract price was £502,303 and the terms of the contract provided that before the delivery of any equipment or materials, the customers were to pay Edward Owen an advance payment amounting to 20 per cent of the contract price; such payment was to be secured by an irrevocable letter of credit. As a condition precedent to the contract itself, Edward Owen was to furnish the Libyan customers a performance guarantee from an acceptable bank for a value of up to 10 per cent of the contract price and on terms that the "guarantee be . . . payable on demand without proof or conditions". Edward Owen arranged with their bankers, Barclays Bank, to provide a performance guarantee on those terms and, in turn, Barclays obtained an indemnity from Edward Owen for the amount covered by the guarantee. The performance guarantee was issued and the contract for glasshouses duly executed.

The Libyan customers then instructed their bankers to open an irrevocable letter of credit in favour of Edward Owen. A letter of credit was sent by the customers' bankers to Edward Owen's bankers, but it was not a letter of credit confirmed by a bank as required under the terms of the contract. Edward Owen brought this discrepancy to the attention of their Libyan customers; but despite several attempts, was unable to arrange for the letter of credit



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to be appropriately amended. Eventually, in desperation, Edward Owen refused to proceed with the contract and wrote to their customers accordingly. The Libyan customer immediately demanded payment on the performance guarantee from Barclays. On hearing of that demand, Edward Owen applied for and obtained an interim injunction from the High Court preventing Barclays from paying out the guaranteed sum. Barclays sought to have the interim injunction discharged and on succeeding before Kerr, J., Edward Owen appealed.

On the facts it would appear that the Libyan customers had defaulted on the contract for the glasshouses and that their conduct in claiming on the performance guarantee under the circumstances was clearly capricious in nature. Nonetheless the Court of Appeal unanimously affirmed the position taken by Kerr, J. in *R. D. Harbottle (Mercantile) Ltd* v *National Westminster Bank Ltd*,[2] a case decided only months earlier, and dismissed Edward Owen's appeal.

Lord Denning in his judgment reasoned that, in effect, a performance guarantee is similar to a confirmed letter of credit and both instruments should therefore be construed on the same footing. He observed that when a letter of credit is issued and confirmed by a bank, the bank must pay if the documents are in order and the terms of the credit are satisfied. Any dispute between the buyer and the seller must be settled separately between themselves. To this general rule his lordship permitted only one exception; and that is when the bank concerned has knowledge that obviou fraud was involved. Applying these principles to the performance guarantee in *Edward Owen*'s case his lordship proceeded to set out, in the following passage of his judgment,[3] what must represent the most succinct statement on the law of performance guarantee as it stands today:

> "All this leads to the conclusion that 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 the question whether the supplier has performed his contracted obligation or not; nor with 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 only exception is when there is a clear fraud of which the bank has notice."

The effect of the Court of Appeal's decision was quickly felt, and following the case, a large number of British contractors immediately reviewed their position in so far as their commitments to existing guarantees were concerned. The harshness of the decision and the ominous possibility that such guarantees could be opened to abuse by unscrupulous clients were conceded by the Court of Appeal. Geoffrey Lane, L.J., in particular, noted in his judgment[4] that:

> "It may be harsh in the result, but the plaintiffs must have been aware of the dangers involved or, if they were not, they should have been aware of them, and either they should have declined to accept the terms of the performance bond or else they should have allowed for the possibility of the present situation arising by making some adjustment in the price."

The English Court of Appeal decision was followed by the Australian case of *Wood Hall* v *Pipeline Authority and Another*[5] decided before the High Court of Australia on an appeal from a decision of the New South Wales Court of Appeal. Wood Hall entered into a contract with the Australian Pipeline Authority for the construction of a natural gas pipeline from South Australia to Sydney. As part of the requirements for the contract, Wood Hall arranged for the Australia and New Zealand Bank to furnish various performance guarantees covering in total a sum of A$2,600,000.00 to the Authority. During the course of the works a number of disputes between the parties arose. It was found necessary to remedy the welds to the

pipes and the cost of these remedial works was estimated at an amount in excess of A$7,000,000.00. The Authority contended that the remedial works were necessitated by the contractor's sub standard workmanship, while Wood Hall maintained that the defects stemmed from the fact that the Authority had failed to provide suitable "first class material" which the Authority was obliged to do under the contract. Wood Hall then presented a claim for A$23,000,000.00 in respect of various contractual breaches allegedly committed by the Authority.

After a course of meetings between the parties, Wood Hall agreed with the Authority to proceed with the remedial works and to defer to a later time the determination of the question concerning liability for the defects. This however turned out to be a "strategy" concocted by the Authority to get the works completed. Just before the project was completed and before the validity of the guarantees expired, the Authority on March 1978 called in the guarantees without prior notice to the contractor. This had the effect of crippling the contractor financially and the Authority used this ploy to their advantage by forcing the contractor to negotiate the welding dispute on terms favourable to the Authority.

In a somewhat unhappy result, the Court, consisting of Barwick C.J., Gibbs, Stephen, Mason and Murphy J.J., held unanimously that the Australian and New Zealand Bank had to honour its unconditional guarantees. It was declared however that once a demand has been made, and the money has been paid, the money must be held as security for the contractor's due and faithful performance of the work. Nonetheless the Court unreservedly emphasised that the obligation to pay on demand is absolute and unqualified; and that accordingly as in the *Edward Owen's* case, the bank had to pay "without proof or conditions". Barwick, C.J. stated in his judgment[6]:

> "In my opinion, there is no basis whatever upon which the unconditional nature of the bank's promise to pay on demand can be qualified by reference to the terms of the contract between the contractor and the owner. Equally there is no basis on which the owner's unqualified right at any time to demand payment by the bank can be qualified by reference to the terms or purpose of that contract."

Gibbs, J. elaborated further[7]:

> "To hold that the bank guarantees are conditional upon the making of a demand that conforms to the requirements of the contract between the Authority and the contractor would . . . be contrary to settled rules governing the implication of terms in contracts. . . ."

The effect of these judicial decisions is to confer on unconditional performance guarantees a highly liquid character that, in the words of Stephen, J. in the *Wood Hall* case, makes them "as good as cash".[8] The position taken by the courts has clearly been prompted by considerations of commercial efficacy. As Stephen, J. puts it admirably[9]:

> "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."

It is difficult to fault this rationale in so far as the matters decided are concerned. The situation as it stands may conceivably be less painful if contractors refrain from associating such unconditional guarantees with the features of suretyship and treat them simply as cash deposits with their clients. The risks presented are no doubt tremendous and the only means available to circumvent them satisfactorily is to take a suitable insurance cover.[10] In the United Kingdom, the Export Credits Guarantee Department (E.C.G.D.) offers a specific insurance policy to cover the capricious calling of unconditional performance bonds. Similar facilities exist in other countries as a means of facilitating construction exports. The drafting of performance guarantees has also received considerable attention since the *Edward Owen* decision. Where possible, performance guarantees should be drafted so that recourse can only be made to them when the party claiming on the guarantee can offer at least some proof of default on the part of the contractor in the latter's performance in the contract concerned. Where an unconditional performance guarantee is unavoidable, a common device suggested these days is to build a self-destruction clause into the bond conditions which would provide to the effect that the bond would become inoperative on a stipulated date. However, the usefulness of this device is questionable as it is open to at least three difficulties. Firstly is still does not prevent the client from calling in the bond before the stipulated date. Secondly any suggestion that the operation of the bond will be limited by time can be illusory, for a client may, if he chooses, compel the contractor to extend the validity of the bond under the threat of calling in the bond. Thirdly the operation of such a clause may be vitiated by the governing law of the guarantee. For instance if a guarantee is required to be governed by Turkish law, such a clause will be of no effect because in that jurisdiction a guarantee remains valid for ten years notwithstanding the stipulation of any time limit to the contrary. Again in Syria the law provides for performance bonds to be effective until the documents themselves are returned to the contractor's bank.

The effect of unconditional performance guarantees as laid down by these decisions represents therefore a new arena of risks; and one will be well advised to proceed carefully. The extent to which these risks could presently be contained is quite limited and in any case is subject to the operation of the governing law of the guarantee.[11] Short of taking a suitable insurance policy to cover these risks there is little else an average contractor could do save to consider his clients carefully before plunging into the depths of bondage.[12]

Footnotes:

1. (1977) 3 W.L.R. 764; (1978) 1 All E.R. 976, before Lord Denning, M.R., Browne and Geoffrey Lane, L.JJ. *Mareva Compania Naviera S.A.* v *International Bulkcarriers Ltd* (1975) 2 Lloyd's Rep. 509 and *The Siskina* (1977) 3 W.L.R. 532; (1977) 3 All E.R. 803, distinguished.
2. (1977) 3 W.L.R. 752; (1977) 2 All E.R. 862.
3. (1978) 1 All E.R. 976 at p. 983.
4. (1978) 1 All E.R. 976 at p. 987.
5. (1979) 24 A.L.R. 385 (Australia). *Australian Conference Association Ltd* v *Mainline Constructions Pte Ltd* (1978) 22 A.L.R. 1; 53 A.L.J.R. 66, distinguished.
6. (1979) 24 A.L.R. 385 (Australia) at p. 387.
7. *ibid.* at p. 392.
8. *ibid.* at p. 397.
9. *ibid.*
10. For a discussion on such insurance, consult the E.C.G.D. booklet *The Services of the British Government's Export Credits Guarantee Department* (London: H.M. Stationery Office 1980); Chow Kok Fong "Protecting Against Financial Risks in International Construction" *Singapore Stock Exchange Journal* March 1980; S. H. Robock "Political Risks: Identification and Assessment" *Columbia Journal of World Business* July-August 1971.
11. The question of the governing law of a contract is itself fraught with uncertainty: see Chow Kok Fong Ascertaining the Governing Law of a Building Contract" *The Quantity Surveyor* July 1980.
12. See Louis Kraar's article in *Fortune Magazine* 24 March 1980 at p. 86; and Sir Horace Phillips "Doing Business with One-Main Regimes" *Asian Wall Street Journal* 29 April 1980.

1980/81 "BCIS Guide to House Rebuilding Costs for Insurance Valuation"

The Building Cost Information Service of the Royal Institution of Chartered Surveyors has published the 1980/81 Edition of its "Guide to House Rebuilding Costs for Insurance Valuation". This is the third edition of the Guide which has become a prime source of information on the assessment of rebuilding costs for domestic property.

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