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Negative Stipulations Prohibiting Calls on Performance Bonds: NSWCA Confirms No Special Requirement for "Clear Words"

The New South Wales Court of Appeal has recently unanimously dismissed an appeal brought against the decision of the Supreme Court in *Laing O'Rourke Australia Construction Pty Ltd v. Kawasaki Heavy Industries Ltd* [2017] NSWSC 541 of 5 May 2017 that saw Kawasaki Heavy Industries Ltd (**Kawasaki**) restrained from calling on certain surety bonds until further order of an arbitral tribunal. The surety bonds totalled approximately AU$50 million and it is believed that this case was the largest value of "on demand" or "unconditional" bonds considered by Australian courts.

We acted for the plaintiff, Laing O'Rourke Australia Construction Pty Ltd (**Laing O'Rourke**), in the proceeding at first instance and as respondent to the appeal.

Background

Kawasaki and Laing O'Rourke had entered into a consortium agreement (**Consortium Agreement**) so that they could be, jointly and severally, the subcontractor under a subcontract with JKC LNG Pty Ltd (**JKC**) for the engineering, procurement and construction of four cryogenic tanks for the Ichthys LNG Project at Blaydin Point, near Darwin in the Northern Territory (**JKC Subcontract**).

Kawasaki extended the security required to be given by the consortium as subcontractor to JKC under the JKC Subcontract (**Kawasaki Bonds**). In turn, Laing O'Rourke provided a number of surety bonds to Kawasaki pursuant to the Consortium Agreement, the value of which exceeded AU$50 million (**Laing O'Rourke Bonds**). The Laing O'Rourke Bonds were to be provided on the same terms and on the same conditions as the Kawasaki Bonds provided to JKC.

Laing O'Rourke and Kawasaki fell into dispute concerning the execution of the JKC Subcontract works and payment for those works. Kawasaki purported to terminate the parties' Consortium Agreement and take over Laing O'Rourke's remaining scope of works.

Anticipating that a call on the Laing O'Rourke Bonds was imminent, Laing O'Rourke approached the New South Wales Supreme Court and obtained an urgent, ex-parte interim injunction before Ball J., restraining Kawasaki from calling on the Laing O'Rourke Bonds. The matter was then contested before Stevenson J. on an interlocutory basis.

The Issue

As is standard with performance bonds in construction contracts, each of the Laing O'Rourke Bonds were expressed on their face as being "unconditional" and "irrevocable". The bonds obliged the issuer to pay to Kawasaki the nominated amount on demand, without reference to and notwithstanding any notice given by Laing O'Rourke not to pay the amount demanded.

Notwithstanding this, Laing O'Rourke argued that there was a serious question to be tried that, on the proper construction of the Consortium Agreement, the Laing O'Rourke Bonds and the Kawasaki Bonds were issued "back-to-back" with the effect that Kawasaki had agreed not to call on the Laing O'Rourke Bonds until (at least) JKC had called on the Kawasaki Bonds. As JKC was yet to make a demand on the Kawasaki Bonds, Laing O'Rourke asserted that it was entitled to an injunction preventing Kawasaki from breaching a negative stipulation not to call on the Laing O'Rourke Bonds absent a call on the Kawasaki Bonds.

Although the relevant Consortium Agreement did not state the circumstances in which Kawasaki were entitled to call on the Laing O'Rourke Bonds, Laing O'Rourke argued that it was clear from the structure of the operative clause in the Consortium Agreement that a prerequisite to that entitlement was a call on the Kawasaki Bonds.

In response, counsel for Kawasaki submitted that Laing O'Rourke must point to "clear words" in the Consortium Agreement inhibiting Kawasaki from calling on the Laing O'Rourke Bonds until a call was made by JKC on the Kawasaki Bonds. In support of this, Kawasaki relied on the following passage from the decision of the Full Court of the Federal Court in *Clough Engineering Ltd v. Oil and Natural Gas Corporation Ltd* (***Clough Case***):[1]

"[C]lear 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, that is, non-fraudulently."

In this sense, Kawasaki suggested that contracts involving surety bonds represented a special type of case whereby the ordinary rules of contractual interpretation did not apply. Rather than construing the contract in the ordinary way, Kawasaki contended that a court must not restrain a party from calling on unconditional bonds unless there are "clear words" in support of that restraint. According to Kawasaki, the unconditional nature of the bonds on their face meant that there was a presumption in favour of a construction that permitted a beneficiary to call on the bonds, providing such a call was made in good faith.

Decision at First Instance

At first instance, Stevenson J accepted Laing O'Rourke's argument that the structure of the Consortium Agreement suggested, very strongly, that it was the intention of the parties that Kawasaki could only call on the Laing O'Rourke Bonds if a call had been made on the Kawasaki Bonds by JKC.

1 [2008] FCAFC 136; 249 ALR 458 at [83].

Stevenson J rejected Kawasaki's submission that it was necessary to find "clear words" before a court could find that there was a negative stipulation prohibiting a call. Similarly, Stevenson J did not accept that the unconditional nature of the bonds on their face necessarily supported a presumption that Kawasaki be entitled to call on the bonds. Instead, this was merely one factor relevant to the correct interpretation of the parties' intentions.

With respect to the correct approach to interpretation of the underlying contract, his Honour held that the question as to the right to call was to be determined in the usual way and by reference to familiar principles, as recently restated in *Simic*[2] at [78]:

> "The proper construction of [a commercial contract] is to be determined objectively by reference to its text, context and purpose."

As the application was for an interlocutory restraint, it was necessary for his Honour to consider whether the balance of convenience favoured injunctive relief.

Although there were a number of factors relevant to the balance of convenience considered by Stevenson J, one factor of significance was the parties' binding "arbitration agreement". At the time of the Supreme Court proceedings, no arbitral tribunal had been established to deal with the underlying dispute. Consequently, Stevenson J noted that Laing O'Rourke could not approach an arbitral tribunal to seek an order from it restraining Kawasaki from calling on the Laing O'Rourke Bonds. If the current restraint was dissolved, Laing O'Rourke would, in substance, forever lose the right to have an arbitral tribunal determine Kawasaki's right to call on the Laing O'Rourke Bonds. In this sense, Stevenson J reasoned that the balance of convenience favoured interlocutory relief to permit this issue to be re-agitated before an arbitral tribunal with the power to alter the relief.

Having found that there was a serious question to be tried as to whether Kawasaki was currently entitled to call on the Laing O'Rourke Bonds and that the balance of convenience comfortably favoured an injunction, Stevenson J ordered that Kawasaki be restrained from calling on the Laing O'Rourke Bonds until further order of an arbitral tribunal.

Decision of the Court of Appeal

Kawasaki appealed the decision of Stevenson J on a number of grounds. However, a key focus of the appeal was whether or not Stevenson J was correct in refusing to embrace a requirement for "clear words" as espoused in the Clough Case.

Kawasaki submitted that the weight of authority in Australia supported the notion that a court will tend only to prevent a beneficiary from calling on unconditional surety bonds in very limited circumstances. To that end, Kawasaki argued that surety bonds could only serve their function as "the life-blood of international commerce" if they were seen to be "as good as cash".[3] This necessarily required, Kawasaki argued, that absent clear words, the surety bonds could be called on as and when the beneficiary seeks to have the cash, subject only to an obligation that the beneficiary act in good faith.[4]

The appeal proceedings required the Court of Appeal to confront the so-called "clear words" principle from the Clough Case and conclusively determine whether or not it stood for some special rule of construction.

In a unanimous decision, the New South Wales Court of Appeal, constituted by Meagher, Payne and White JJA, held that Clough does not stand for the proposition that there is a special rule of construction relating to obligations regarding an entitlement to call on performance bonds[5]. Instead, the Court of Appeal held that the requirement for "clear words" applies only when the correct construction of the contract between the parties was that the parties intended for the performance bonds to serve as a risk allocation device as to which party will be out of pocket in the event of a dispute.[6] Any broader interpretation of the Clough Case, the court held, would be inconsistent with the decision of the High Court in *Simic*.[7]

Importantly, the court noted that it will not necessarily always be the case that the parties' intention was for unconditional surety bonds to have a risk allocation purpose. While the typical language of a surety bond may tend to support the finding that a surety bond was intended to be a "risk allocation device", the court held that such a label needed to be justified by an orthodox process of contractual interpretation and not by assuming any special rule of contractual construction was applicable.[8]

Ultimately, the Court of Appeal agreed with Stevenson J's conclusion that the Consortium Agreement pointed to the parties having intended that the Laing O'Rourke Bonds secured a liability to Kawasaki that was only triggered when JKC made a call on the Kawasaki Bonds. Accordingly, the Court of Appeal ordered that Kawasaki's appeal be dismissed.

2 *Simic v. New South Wales Land and Housing Corporation* [2016] HCA 47 (***Simic***).

3 [2017] NSWCA 291 at [44].
4 Ibid, [45].
5 Ibid, [60].
6 Ibid, [62].
7 Ibid, [64].
8 Ibid, [67].