

**PERFORMANCE AND  
PAYMENT SECURITY—  
BORAL FORMWORK V  
ACTION MAKERS [2003]  
NSWSC 713**

Reece Allen  
Solicitor

Gadens Lawyers, Brisbane

**INTRODUCTION**

Construction contracts usually require the contractor to provide performance or payment security. The importance of an appropriate security instrument governing performance and payment on construction projects cannot be overstated given that usually at least 10 per cent of the contract sum is supported by such security. However, despite the importance of performance and payment security the differences between the various security instruments are not often understood. In this context, this article discusses:

- common security instruments such as unconditional bank guarantees, standby letters of credit and surety bonds;
- exceptions to the autonomous nature of such security instruments; and
- the decision of the Supreme Court of New South Wales in *Boral Formwork v Action Makers* [2003] NSWSC 713 (*Boral*) which held that an unconscionable demand on a security instrument may breach sections 51AA and 51AC of the *Trade Practices Act 1974* (Cth).

**PARTIES**

A security instrument involves three parties:

- (1) the account party—the party who has procured the security from a bank or insurance company;
- (2) the beneficiary—the party entitled to payment under the terms of the security; and
- (3) a bank, insurance company or surety company (generally referred to in this article as ‘bank’)—the financier liable to make the payment to the beneficiary under the terms of the security.

Agreements related to the transaction include the underlying contract between the account party and the beneficiary and the counter security or indemnity (such as a mortgage or charge) provided by

the account party to the bank to secure the security instrument.

**REASONS FOR SECURITY**

The primary purpose of any performance or payment security is to provide security to the beneficiary against default by the account party in the underlying contract. Other common purposes of performance or payment security include:

- to secure an advance payment required under the underlying contract;
- where the payment obligation arises without proof of default, to protect the beneficiary from carrying credit risk during the course of dispute with the account party under the underlying contract.<sup>1</sup> This helps the beneficiary to put pressure on the account party to encourage settlement of a dispute;
- to provide an incentive to the account party to complete all their obligations under the underlying contract in accordance with the underlying contract; and
- in lieu of money that would otherwise be retained under the contract (e.g. cash retention in a construction contract).

To achieve these aims, the security instrument must be irrevocable and unconditional. The commercial character requires that they be ‘as good as cash’ in the eyes of the beneficiary and this unconditional nature is essential to the instruments function.<sup>2</sup> Once an instrument ceases to be the equivalent of cash, that is being instantly and unconditionally convertible to cash, it loses its commercial currency and acceptability.

**TYPES OF PERFORMANCE  
AND PAYMENT SECURITY**

Security instruments issued by banks and insurance companies can take many forms. The key instruments are as follows.

## Documentary Letter of Credit

A documentary letter of credit is an agreement between an account party and a bank under which a bank irrevocably undertakes to pay the beneficiary upon production of stipulated documents. The primary purpose of a documentary letter of credit is to ensure that the supplier of goods or services (the beneficiary) will be paid upon supply or delivery by presenting the documentary letter of credit to the bank. Once a bank pays under the documentary letter of credit, the bank is reimbursed by the purchaser as account party. For example, in a commercial transaction where goods are being shipped, a bank issuing a documentary letter of credit will undertake to pay an exporter upon production of a bill of lading and then the bank is reimbursed by the importer. Such an arrangement provides the exporter of goods with an assurance of payment.

## Stand-By Letter of Credit

By comparison, a stand-by letter of credit requires production of documents which evidence money owing but unpaid by an account party to a beneficiary under an underlying contract, normally suggesting a breach of the underlying contract. A stand-by letter of credit is similar to an unconditional bank guarantee, but the primary obligation of the financier is payment upon receipt of documents rather than presentation of the unconditional bank guarantee itself. The documents required are listed in the terms of the security instrument, but may include matters such as a judgment, arbitral award or a certificate, such as a certificate of default, given by the beneficiary to the account party itself.<sup>3</sup>

## Unconditional Bank Guarantee

Unconditional bank guarantees (also called 'first demand guarantees' or 'on demand guarantees') are similar to letters of credit except that they do not normally require the production of any documents. Rather, an unconditional bank guarantee is an unconditional undertaking by a bank to pay an amount of money to the beneficiary upon the beneficiary making a demand for payment to the bank, usually up to a stipulated amount.<sup>4</sup> The unconditional bank guarantee is expressed in terms not conditioned by the terms of the underlying contract. In this sense, a proper unconditional bank guarantee is unconditional, irrevocable (in that it cannot be revoked by the account party or the bank until expiry) and autonomous. Although they perform a similar function to a guarantee, bank guarantees are not guarantees at all because there is no surety (i.e. guarantee of performance) given by the bank. Rather, they are simply instruments where once a demand is made on them within the terms of the instrument payment is made by the bank.

Unconditional bank guarantees can be contrasted with conditional bank guarantees where the obligation of the bank to make payment is conditioned upon the account party actually being in default and the beneficiary provided evidence to the bank of such default (e.g. a notice of default). With unconditional bank guarantees, if presented the bank must make payment irrespective of whether there is evidence of default in the underlying contract. This liquidity is required so that the guarantees are as good as cash.

## Surety Bonds

A surety bond (sometimes known as a 'performance bond' or 'insurance bond') is issued by an insurance company or specialist surety company rather than a bank.

A surety bond usually has these key elements:

- the surety guarantees to the beneficiary the performance of the account party under the underlying contract, sometime for the entirety of the account party's obligations;
- if the account party defaults, normally the surety will have a right to step in and complete the transaction or engage another party to complete the transaction rather than pay out money to the beneficiary; and
- a surety bond is conditional and therefore a true guarantee because it is a secondary obligation on the part of the surety should the account party default. Conditions usually include a requirement for a statement by the beneficiary that the account party is in default and that the money is not payable 'on demand' but at the end of the transaction.

In Australia unconditional bank guarantees are the preferred form of security for principals (see e.g. Annexure C of AS4300-1995) and therefore surety bonds are not common.

## Autonomy Principle

Standby letters of credit and unconditional bank guarantees share the fundamental concept that they are 'autonomous' from the underlying contract. The 'autonomy principle' means that a beneficiary is entitled to make demand for payment, and the bank is obliged to meet that demand, regardless of whether or not the account party is in default under the underlying contract. Because the autonomy principle is a fundamental characteristic of security instruments, the courts are very reluctant to provide an injunction restricting a party from obtaining payment from a bank under a security instrument. However, the law has developed various exceptions to the autonomy principle discussed below.<sup>5</sup>

## Fraud

A court may grant an injunction restricting a party accessing a bank guarantee where there has been fraud on the part of the beneficiary, such as a dishonest intent or recklessness as to the truth of a statement. For example, if there has been no default in the underlying contract, and a beneficiary fraudulently represents that there has been default, then payment under the bank guarantee may be restrained for fraud. However courts insist on very strong evidence of fraud, that 'it is usually arguable that fraud is the only realistic inference'.<sup>6</sup>

## No Underlying Contract

The underlying contract describes the scope of the beneficiary's right to present the guarantee or letter of credit for payment. As a result, if there is no underlying contract on foot, such as where the contract is void due to illegality or where there never was a contract, then it is logical that the beneficiary has no right to present a security instrument for payment. Similarly, where a contract has been terminated or frustrated, there may not be a right to present a guarantee for payment, unless that right arose prior to the effect of date of termination or frustration.

## Defective Demand for Payment

If a bank pays a beneficiary, or proposes to pay a beneficiary in circumstances not contemplated by the terms of the bank guarantee or letter of credit, then the account party may seek an injunction restricting such a payment. For example, if the correct documents were not presented, it would be inappropriate for the bank to pay the beneficiary under the terms of the stand-by letter of credit.

## Unconscionability

Another exception to the autonomy principle is where it is unconscionable for the beneficiary

to call upon the bank guarantee or letter of credit. Unconscionability generally involves 'taking advantage of a special disadvantage of another' or 'unconscientious reliance on strict to legal rights' or 'action showing no regard for conscience, or that are irreconcilable with what is right or reasonable'.<sup>7</sup> A court may invoke the exception to the autonomy principle where it is clear that a demand on an unconditional bank guarantee or letter of credit infringes the above concepts. This is discussed further below in the circumstances of *Boral* case.

## Breach of a Negative Stipulation in the Underlying Contract

A court may grant an injunction to restrain a breach by the beneficiary of either an express or implied negative stipulation in the underlying contract. Thus, where calling on the security would be a breach of the underlying contract, the courts may restrain a beneficiary from invoking the financier's autonomous obligation. This can be described in another way, that is, the underlying contract provides circumstances in which the beneficiary may demand payment, and that the beneficiary has, in breach of that underlying contract, made a demand beyond those circumstances. However, because the bank guarantee or letter of credit and the underlying contract are separate contracts, the courts will be quite reluctant to interfere except where it is clear that there is a breach of the underlying contract.

## Lack of Good Faith/Absence of Reasonableness

Implied terms of good faith have been recognised in some states.<sup>8</sup> Similarly, the underlying contract may contain good faith provisions. It is at least arguable that access to a guarantee or letter of credit may constitute a breach of an obligation of good faith, or an absence of reasonableness, where such a

guarantee is accessed in circumstances where the underlying contract does not permit such access.

## Statutory Exceptions—*Boral v Action Makers*

Because of the hierarchy of obligations (statute, contract and common law) the autonomy principle cannot override statute. Therefore, the courts may grant an injunction restricting access to an unconditional bank guarantee or standby letter of credit if such access infringes a statutory provision.

### **BORAL V ACTION MAKERS**

In this case, Action Makers undertook to supply to Boral containers of scaffolding equipment. Boral provided Action Makers with a standby letter of credit to secure payment for the equipment. After delivery of the initial 18 containers of equipment, Boral complained about defects in the equipment. Subsequently, Action Makers went into liquidation. On 21 February 2003, Boral notified the administrative receivers of Action Makers that Boral would, as it was entitled to do so under the contract, effect necessary rectification work to the equipment and deduct the cost of the rectification work from the contract price. Boral further notified the administrators on 11 March 2003 that the rectification work had been performed at a total cost of \$98,825.92.

On 5 June 2003, without having replied to Boral's earlier correspondence, the administrators acting on behalf of Action Makers made a demand for payment of the full invoice amount for each of the 18 containers provided. On the same day that the demand for payment was made to Boral, the administrator made a demand on the bank for payment under the standby letter of credit for the full amount of the invoices, without any set-off for the rectification work

performed by Boral. Boral subsequently sought an injunction restricting access. That injunction was granted *ex parte* by Campbell J.<sup>9</sup> Austin J subsequently dealt with the proceedings on a final basis. Boral sought relief on three grounds:

- (1) on the basis of an implied negative stipulation in the underlying supply agreement;
- (2) pursuant to section 51AC of the *Trade Practices Act 1974* (Cth) (*TPA*) (unconscionable conduct in business transactions); or
- (3) pursuant to section 51AA of the *TPA* (unconscionable conduct within the meaning of the unwritten law (i.e. common law)).

His Honour subsequently rejected the first contention that there was an implied negative stipulation in the supply agreement that did not permit Action Makers from accessing the letter of credit in the manner in which it had done so. This is because the supply agreement was silent as to the circumstances in which the beneficiary of the letter of credit may make a demand payment under it. His Honour held that the natural conclusion was that there was no contractual limitation on Action Makers making a demand on the letter of credit. Thus, the supply agreement did not expressly deal with the effect of a reduction in the invoice price (for defects) upon Action Makers' ability to make demands on the letter of credit. Therefore, His Honour refused to imply a term requiring set off prior to Action Makers accessing the standby letter of credit.

### TRADE PRACTICES CASE

Austin J concluded that when the administrator produced the beneficiary certificate to the banks under the standby letter of credit:

- the certification that the complete invoice amount due to be paid by Boral to Action Makers was false;

- in fact the only amount due to be paid by Boral was the invoice amount less the cost of rectification work; and

- the administrator of Action Makers had made a misleading statement in certifying that a demand for payment had been made against Boral and had remained unsatisfied, because it suggested the expiry of some interval of the time between the demand and certificate, whereas a demand for payment was made on the same day as the certificate.

The question for His Honour to determine was whether in calling for payment of the invoice amount and supplying the certificate under the standby letter of credit, Action Makers was (by the administrative receivers acting as its agent) engaging in unconscionable conduct under the *TPA*.

### UNCONSCIONABLE CONDUCT UNDER THE UNWRITTEN LAW

Section 51AA of the *TPA* brings into the statutory regime the general equitable principles of unconscionability under the law of each State. After examining concepts of unconscionability in equity, His Honour held that it was appropriate to make declarations and orders under section 51AA because under the standby letter of credit, Action Makers had claimed an amount that was not due, because:

- the disputed amount was effectively settled by virtue of the administrative receivers' acquiescence in Boral undertaking repairs as indicated in its letter dated 21 February 2003 and email dated 11 March 2003; and

- notwithstanding that acquiescence Action Makers made a call on the full amount of the letter of credit as if the repairs and Action Makers acquiescence had not occurred.

## UNCONSCIONABLE CONDUCT IN BUSINESS TRANSACTIONS

His Honour further considered whether Action Makers' conduct breached section 51AC(1) of the *TPA*. The Boral transaction fell within the ambit of section 51AC because it was in trade and commerce and the monetary limit of the supply was less than \$3 million. His Honour held that, for the same reasons outlined in his findings under section 51AA, the conduct of the administrative receivers acting as agents for Action Makers was unconscionable within the words of section 51AC. He held that it was unconscionable for Action Makers to use its rights under the letter of credit by certifying that payment of the whole invoice amount was due, when an amount should have been set off for the rectification work performed by Boral. Therefore, Action Makers' conduct was 'action showing no regard for conscience, or that irreconcilable with what is right and reasonable'.<sup>10</sup>

His Honour also held that the word 'unconscionable' in section 51AC is not limited to conduct that would be unconscionable according to equitable principles, both the equitable principles and section 51AC are applicable.

His Honour subsequently held that because the actions of Action Makers was unconscionable within the meaning of sections 51AA and 51AC, Boral was entitled to orders requiring Action Makers to countermand the demand for payment of the disputed amount and restrain it from making further demands. Thus, His Honour held that within the circumstances of the case, the calling on of the letter of credit on a false basis was 'sufficiently special to overcome the hesitation which the principle of autonomy generates'.<sup>11</sup>

## CONCLUSION

The decision in *Boral* shows the far reaching implications of the *TPA* in trade or commerce in Australia. Therefore, when advising parties making or defending any demands for payment under bank guarantees, a solicitor should consider:

- the terms of the security instrument;
- the underlying contract;
- the exceptions to autonomy under the common law; and
- any statutory exceptions that may apply.

---

## REFERENCES

1. *Boral Formwork v Action Makers* [2003] NSWSC 713 (*Boral*) at paragraph [36].
2. See *Wood Hall Ltd v Pipeline Authority* (1979) 141 CLR 443 per Stephen J at p457.
3. *Boral* at paragraphs [33] and [34].
4. See *Boral* at paragraph [35] and Bailey J *Unconditional Bank Guarantees* [2003] ICLR 240 at p241 (Bailey).
5. See Bailey at pp261–273.
6. See Bailey at p261. For a discussion of the fraud exception see *Olex Focas Pty Ltd v Skodaexport Co Ltd* [1998] 3 VR 380 per Batt J at p395 (*Olex*).
7. See Bailey at p266; *Commercial Bank of Australia v Amadio* (1983) 151 CLR 447 per Mason J at p461.
8. For example, in New South Wales see *Renard Constructions (ME) Pty Ltd v Minister for Public Works* (1992) 26 NSWLR 234. The High Court has not yet recognised implied terms of good faith. For a discussion of good faith see Allen R 'Would you like good faith with that?' (2001) 21(11) *Proctor* 26.

9. *Boral Formwork & Scaffolding Pty Ltd v Action Makers Limited* [2003] NSWSC 557 before Campbell J (*ex parte* injunction granted). For another case considering the application of the *TPA* to a demand on a bank guarantee see *Olex* per Batt J at p401.

10. *Boral* at paragraph [88] quoting the Full Federal Court in *Hurley v McDonalds Australia Limited* [2000] ATPR 41, 741 at p4, 585.

11. *Boral* at paragraph [94].