

Pulling the Guarantees

Standard form construction contracts in Australia usually provide for security to be provided by contractors in relation to their performance. Often this is in the form of a retention fund, where a percentage of each progress payment is retained by the principal until a certain limit is reached. This fund is returned to the contractor upon satisfactory completion of the job: usually half at practical completion and half at final completion.

Alternatively, the contracts provide that the contractor may furnish security for the performance of the contract (called here "the guarantees") from a bank or other suitable financial institution. The guarantees are almost invariably required to be unconditional. The principal can then have recourse to the security provided by cashing or "pulling" the guarantees.

The impact of the recession has led to an increase in principals seeking to pull the guarantees, prompting contractors to seek injunctions to stop them. Contractors have argued that, first, the construction contracts limit the circumstances under which the guarantees can be pulled, and second that they could not be compensated for damage to their commercial reputation if the guarantees were pulled. Principals have responded that, where guarantees are said to be unconditional, they should be treated as such.

Previous cases have established two situations which affect the principal's and contractor's rights. These depend on the drafting of the clause in the contract allowing the principal to convert the guarantees into cash, and the drafting of the guarantees themselves.

With a Limiting Clause in the Contract

In the first situation the construction contract qualifies the principal's right to pull the guarantees. In a NSW case heard in 1982, *Pearson Bridge (New South Wales Pty Ltd v State Rail Authority of New South Wales)* (1982) 1 ACLR 81, the relevant clause [which followed the wording in NPWC 3 (1981) - the clause in AS 2124 (1986) is essentially the same], stated:

"If the Principal becomes entitled to exercise all or any of his rights under the Contract in respect of the security the Principal may convert into money the security that does not consist of money".

Justice Yeldham decided that the clause defined and limited the circumstances under which the principal could convert any security into money. The threatened breach of the security clause entitled the contractor to an injunction.

In a 1991 case, *Hughes Bros Pty Limited v Telede Pty Limited* (1991) 7 BCL 21, the equivalent clause in JCCA 1985 was considered. Justice Cole stated that the contractor will not be entitled to an injunction to prevent the

pulling of the guarantees where: (1) the principal is entitled to pull the guarantees despite the limiting clause; and (2) the claimed entitlement is not specious or fanciful.

No Limiting Clause in the Contract

Where the guarantees are truly unconditional, and the contract does not contain a clause limiting the rights of the principal to convert the security, the contractor will not be able to obtain an injunction when the guarantees are called upon. The High Court, *Wood Hall Limited v The Pipeline Authority* (1979) 141 CLR at 443, having established that pulling the guarantees did not constitute a breach of contract by the principal, decided that no injunction would be granted to prevent them from being pulled.

However, the court held that the security funds, once cashed, had to be retained by the principal as security for the performance of the work by the contractor. Any balance remaining had to be released to the contractor in accordance with the contract provisions.

Once the guarantees have been pulled

Where the guarantees have already been pulled and the money paid, the principal can argue that damages (if any) are the appropriate remedy — the loss to the contractor's reputation has by that stage already occurred. But the contractor may be able to show that it will still suffer a loss it could not be compensated for unless a further order is made restraining the principal from taking the proceeds of the guarantees.

Alternatively, the contractor may argue that the funds that are the subject of the guarantees, once pulled, are held on an express or resulting trust. Therefore, if the contractor can demonstrate that there is evidence of a breach of the terms of the trust by the principal, an injunction should be granted.

In mid 1990, a judge of the NSW Supreme Court found, *Sabemo Pty Limited v Malaysia Hotel (Aust) Pty Limited* (unreported, Supreme Court of New South Wales, 22 June 1990), that there had been a breach of contract by the principal in pulling the guarantees and restrained the principal from further dealing with the money. The judge also stated that the contractor may be entitled to additional relief and, upon providing a new guarantee, the principal should repay the money to the contractor.

Finally

It will almost always be possible to obtain an injunction where evidence is produced to convince a judge that the pulling of the guarantees would be fraudulent.

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