Security - On Demand and Guarantee Bonds - Obscure Drafting Condemned

Trafalgar House Construction (Regions) Ltd v General Surety & Guarantee Co Ltd [1995] 3 WLR 204.

If parties intend to create an "on demand" bond they should not use the language of guarantees.

A recent decision of the United Kingdom House of Lords highlights the importance of careful and clear drafting of performance bonds, one of the foundations of the construction industry. Otherwise there is a risk that a performance bond will be construed more narrowly or more broadly than the parties intended.

The decision is of interest in Australia, and not just in the construction industry.

USE IN PROJECT FINANCINGS

Financiers in a project financing will often require some form of recourse to a third party in case an independent contractor fails to fulfil its project obligations. Often that recourse is provided by bank undertakings, like letters of credit which are almost as good as cash collateral. However, if financiers are willing to have recourse to a non-bank financial institution or other creditworthy entity, bank undertakings will not be appropriate. In that case, a performance or "guarantee" bond (sometimes also called an "insurance" bond, if provided by an insurer) could be provided.

In essence, such a bond is simply a contractual undertaking by a third party to pay a specified sum to the beneficiary of the bond in certain circumstances. The recent House of Lord's case emphasises that there are two types of performance bond, and it is important not to confuse them.

TYPES OF PERFORMANCE BOND

- A bond which is an undertaking simply to pay money "on demand". The intention here is for the beneficiary to be able to claim under it without showing that there has been any breach by the relevant contractor, and without showing any damage suffered. The beneficiary's claim under the bond can usually only be resisted if it is made fraudulently.

  This is the type of performance bond usually required today in Australia.

- True guarantee bond, in which the party liable under the bond is liable as a guarantor or surety only. Therefore that party can take advantage of all the defences normally available to the principal contractor, whose obligations are guaranteed.

  This type of bond is common in certain parts of the United Kingdom construction industry. However, due to its limited scope, financiers in Australia usually wish to ensure that any performance bond granted in their favour is not a guarantee bond.

HOW TO DISTINGUISH THEM - DRAFTING AND COMMERCIAL PRACTICE

Whether a bond is truly an "on demand" bond or a guarantee bond depends primarily on how it is drafted. However, the House of Lords noted that the bond in that case was "archaic" in form. (Therefore, it will not be quoted here.)

Commercial Practice

Faced with an obscurely drafted bond, the House of Lords gave overriding significance to the manner in which the construction industry in the United Kingdom had treated similarly worded bonds for the last 150 years. Overturning the Court of Appeal's decision, it held that the bond in question was a true guarantee bond, even though it had elements of an "on demand" bond.

Drafting

In support of that conclusion, the House of Lords noted that the party liable under the bond was described as a "surety". It also relied on the fact that the bond contained a clause (usual in guarantees) which states that an amendment to the relevant contractor's obligations will not affect liability.

In Australia

These conclusions should be contrasted with previous statements made by the High Court of Australia. (*Wood Hall Ltd v The Pipeline Authority* (1979) 141 CLR 443.) In 1979, Chief Justice Barwick held that inclusion of such a clause did not mean that the bond was a true guarantee bond. Rather, that clause was simply included "as a precaution".

Moreover, he held that even calling the bond a "guarantee bond" was "a complete misnomer" and did not mean that it was a true guarantee bond. The High Court in that case held that the bond was an "on demand" bond.

Clarity In Drafting Must Be Paramount

Parties should not take comfort from this approach of ignoring express wording used in a document, because:

- courts are only likely to ignore express words if they

conclude that the express words are, in all the circumstances, ambiguous;

- also, it will not always be possible to point to consistent and long-standing commercial practice to resolve uncertainties.

So, if parties intend to create an "on demand" bond they should not use the language of guarantees. Bonds must be drafted to embody the parties' true intentions clearly and concisely - abandoning, if necessary, historical form of words.

The House of Lords wondered:

"Why business men persist in entering upon considerable obligations in old-fashioned forms of contract which do not adequately express the true transaction ... It is certainly not the fault of lawyers."

Whether or not the last sentence is true, the message clearly is that drafting of performance bonds must be approached with caution.

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