

Is your bank guarantee really guaranteed?

By Jennifer Long

Bank guarantees are one of the most common features in commercial contracts and are an integral part of ensuring contractual compliance and providing security for performance. They are used for a variety of reasons, sometimes provided in addition to, or in substitution of other forms of security. The most common use of bank guarantees by Local Governments is as a form of security in retail or commercial leases, in works and construction contracts to rectify defects, in supply agreements to secure supplier's obligations and in development and bonding agreements to secure the performance of obligations.

Legal pitfalls can however arise when enforcing guarantees and beneficiaries are increasingly being prevented from calling on bank guarantees in circumstances where that party thought it had sufficient protection. However one can mitigate against risk exposure to ensure rights remain effective, by being aware of what to look out for when entering into contractual relations or accepting a bank guarantee.

Is there a general right to recourse?

Historically there has been a line of judicial authority that supports that a bank guarantee, by its very nature is unconditional, and that the Bank undertakes to pay according to its guarantee, on demand, without proof or conditions¹.

It is also widely accepted that there are three principal exceptions to the rule that a court will direct the issuer of a bank guarantee from performing its unconditional obligation to pay the beneficiary:

1. to prevent the beneficiary from acting fraudulently;
2. to prevent the beneficiary from acting unconscionably; or
3. In circumstances where there has been a contractual promise by the beneficiary not to call on the guarantee².

Recent judicial decisions have emphasised that the 'primary focus' will always be the proper construction of the underlying contract or agreement but that the Court should not readily favour a construction which erodes or frustrates the purpose for the provision of security³. In *Universal Publishers Ltd v Australian Executors*⁴, the New South Wales Supreme Court held that the landlord was not entitled to exercise its rights under the bank guarantee unless it had first obtained a court order that the tenant had committed a breach. The Court asserted that the Landlord's ability to claim under a bank guarantee will depend on the terms of the lease which are applicable to the bank guarantee.

In addition, the Victorian Supreme Court recently held that a contractual obligation for a beneficiary to act "reasonably" in making a claim against a bank guarantee, precluded the beneficiary from making the claim⁵.

The right of recourse to a bank guarantee will therefore, be strictly construed in accordance with the provisions of the contract or agreement under which it was provided, placing a greater emphasis on ensuring the underlying agreement is appropriately drafted.

Is a Bank Guarantee safe in the event of insolvency?

Upon insolvency, an appointed liquidator can attempt to recover an unfair preference under section 588FH of the *Corporations Act 2001 (Cth)*.

Due to the fact Bank Guarantees are issued by a bank in the name of a beneficiary, they have generally not been considered to be 'preference payments' and therefore fall outside the scope of the preference payment regimesafe from the demand by a liquidator. However it has recently been held that in circumstances where a transaction or payment made by a third party such as a bank 'by or on behalf' of the debtor, at its discretion, is likely to constitute a preference payment under section 588FA of the *Corporations Act*⁶.

Therefore, in limited circumstances, such as when a payment is made pursuant to a call on a bank guarantee less than six months prior to the appointment of a liquidator, a payment made under a bank guarantee may be recoverable by a liquidator.

How to safeguard your Bank Guarantee

With the sense of security a bank guarantee provides, these are all too often accepted without much scrutiny and sometimes in the absence of an appropriate contract. However as recent judicial decisions have indicted in some instances, this may actually be a false sense of security.

That being said, a bank guarantee is still a very effective form of security when constructed appropriately. Some key considerations to assist in navigating and mitigating potential risks include ensuring:

1. a formal contract or agreement governs the agreement, with appropriate bank guarantee provisions to bind the parties;
2. careful consideration has been given to the terms of the underlying contract or agreement as well as the actual terms of the bank guarantee. In particular ensuring that:
 - i. the bank guarantee and agreement provide an unqualified unfettered right to be called upon in whatever circumstances the Local Government (as beneficiary) sees fit without notice and notwithstanding any dispute, objection, claim or direction by the contracting party to the contrary;
 - ii. the bank guarantee is issued from an Australian Trading Bank;
 - iii. the bank guarantee does not have an expiry date and will continue until notification has been received by the beneficiary that the security is no longer required; and
 - iv. the basics are correctly stated.

3. a right of discretion is provided, enabling the Local Government to approve or disapprove the form of an unconditional undertaking and the financial institution providing it;
4. regular compliance checks are undertaken to ensure that bank guarantees remain valid and the security they provide is sufficient;
5. if there are concerns about the financial stability of the contracting party, seek advice to explore alternative or additional security to mitigate any risks; and
6. any new guarantee provided should be provided prior to expiry and/or cancellation of the preceding guarantee.

For further information in regard to the above, contact Jennifer Long on 9424 6224 or jlong@mcleods.com.au. The information contained in this article should not be relied upon without obtaining further detailed legal advice in the circumstances of each case.

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