The Latest from the High Court on Performance Bonds: Simic v New South Wales Land and Housing Corporation [2016] HCA 47 7 December 2016

Snapshot

- Performance bonds are regularly employed by parties in a vast range of commercial enterprises including, most notably, in international commerce and in property transactions.

- They are to be construed in accordance with the usual principles of contractual interpretation.

- However, the dual principles of strict performance and autonomy which are generic to performance bonds means that unlike ordinary contracts, no resort can be had to the underlying contract (that is, the agreement pursuant to which a performance bond has been issued) in construing the obligations under the bond.

Introduction

Performance bonds, sometimes called bank guarantees, are typically issued by a financial institution at the request of a party to a contract. Performance bonds are often issued pursuant to an obligation contained in a construction contract. They take the form of a promise by the issuing institution that it will pay to the beneficiary named in the bond, an amount up to the limit set out in the bond unconditionally or on specified conditions and without reference to the terms of the contract between the parties.

The primary question in this case, determined by the High Court of Australia on 7 December 2016, was whether the second respondent (**ANZ**) as the issuer of a performance bond, had an obligation to pay on demand of the New South Wales Land and Housing Corporation (**Corporation**), a party claiming to be the beneficiary which, due to an error on the part of the requesting party, was not the beneficiary actually named in the bond.

That case turned on the following issues:

1. Whether, as a matter of construction, it is possible to regard the Undertakings as being in favour of the Corporation, instead of a named "Principal" that did not exist; and

2. If not, should the Undertakings be rectified so that each is in favour of the Corporation?

The Facts

ANZ on the instructions of the third respondent (**Nebax**), a company of which the first appellant, Mr Simic, was a director, issued two instruments, each in the form of

an unconditional promise to pay (**Undertakings**), in favour of a named "Principal" that did not exist: "New South Wales Land & Housing Department trading as Housing NSW."

Mr Simic gave Ms Hanna, an officer of the ANZ, the details to enable her to generate the Undertakings using a computer template. Mr Simic did not give Ms Hanna a copy of the Construction Contract or a copy of the draft Unconditional Bankers Certificate.

The Corporation made a demand for payment under each Undertaking. ANZ did not pay on the demands because the Corporation was not the named Principal.

The Court of Appeal

In approaching the constructional question, Emmett AJA (with whom Bathurst CJ and Ward JA agreed), who wrote the leading judgment in the Court of Appeal, held that ordinary principles of construction were applicable. His Honour approached the question of construction on the basis that it was anterior to the principle of strict compliance, which he held pertained to performance.

The principle of autonomy went to construction because it was directed to the question as to which documents could be employed for the purpose of determining what the performance bonds meant. It was therefore permissible to have regard to the construction contract to that extent in order to determine the correct construction of the Undertakings.

The Court of Appeal thus concluded that upon the proper construction of the Undertakings, the defined "Principal" meant the Corporation and, it followed, "*once the Corporation had furnished to ANZ indisputable evidence that it was the entity that was a party, as 'Principal', to the contract or agreement with Nebax described in the Undertakings, there was no basis upon which ANZ would be entitled to refrain from meeting the demand*"[1] . Emmett AJA did not deal with the question of rectification.

The High Court

Consistent with established banking practice, no party contended that the Undertakings were to be construed otherwise than in accordance with ordinary principles of contract construction. There was also no dispute about those principles of construction.

Proper construction of the Undertakings

The Court said that a proper construction of each Undertaking is to be determined objectively by reference to its text, context and purpose: *Electricity Generation Corporation v Woodside Energy Ltd*: "[*T]he objective approach [is] to be adopted in determining the rights and liabilities of parties to a contract. The meaning of the terms of a commercial contract is to be determined by what a reasonable businessperson would have understood those terms to mean. ... [I]t will require consideration of the language used by the parties, the surrounding circumstances*

[1] Simic v New South Wales Land and Housing Corporation [2015] NSWCA 413 at [114]

known to them and the commercial purpose or objects to be secured by the contract. Appreciation of the commercial purpose or objects is facilitated by an understanding 'of the genesis of the transaction, the background, the context [and] the market in which the parties are operating'."[2]

The starting point for the proper construction of the Undertakings is the language used in each Undertaking. "ANZ was obliged to pay a stipulated amount without regard to the performance or non-performance of any party to that 'contract or agreement'"[3].

The Court held, for the reasons including those following, that it was not open to construe "New South Wales Land & Housing Department" where it appeared as the "Principal" in each Undertaking as referring to the Corporation.[4]

First, the Corporation and a "department" of the New South Wales Government are legally distinct. The Corporation is a statutory corporation that can sue and be sued in its own name. By contrast, a department of the New South Wales Government is an emanation of the Crown in the right of the State of New South Wales.

Second, although the "contract or agreement" referred to in each Undertaking provides a link to the Corporation which is significant for the purposes of rectification, it is either irrelevant or of no assistance for the purposes of construction. "*That is because, subject to fraud perpetrated by a beneficiary, an instrument of this nature (unconditional promise to pay on demand) is independent of any underlying transaction and any other contract. That principle – the principle of autonomy – reflects that those instruments, by their nature, stand alone. Not only are they equivalent to cash but, by their terms, they also require that the obligations of the issuer are not determined by reference to the underlying contract. The principle of autonomy dictates that the surrounding circumstances and commercial purpose of the Construction Contract are different from those of the Undertakings*."[5]

Third, the inability to construe the "Principal" named in each Undertaking as the Corporation is impelled by the commercial purpose or objects of such an instrument. The Court noted that letters of credit or documentary credits, and performance bonds or guarantees both involve an undertaking, usually by a bank, to make payment on satisfaction of certain conditions. In each case, the issuer is not required or intended to be concerned with the terms of the underlying contract or, subsequently, with whether the favouree or beneficiary of the security has sufficiently performed its obligations under that contract.

Fourth, the inability to construe the named "Principal" as referring to the Corporation was necessitated by commercial reality. In issuing a banking instrument of this nature, the issuer relies upon, and acts in accordance with, the instructions of the applicant, and is contractually bound to do so. The fact that the applications were completed based on incorrect instructions did not alter ANZ's contractual relationship with Nebax.

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[2] 251 CLR 640 at 656-657 [35]; [2014] HCA 7;
[3] Gageler, Nettle, Gordon JJ at [82]
[4] French CJ at [10]; Kiefel J at [31]; Gageler, Nettle, Gordon JJ at [84]-[101];
[5] Gageler, Nettle, Gordon JJ at [85]

Lastly, the principle of strict compliance dictates that an issuer of a performance bond should only accept documents that comply strictly with the requirements stipulated in an instrument of this nature. The principle is fundamental to the efficacy and dependability of banking instruments such as the Undertakings.

This point was eloquently made in the judgment of Kiefel J in which her Honour said, "*ANZ was obliged only to pay the amount specified to the entity named in the Undertakings, upon production of the original Undertakings and a demand for payment. No process of construction could effect the inclusion of the Corporation's name in lieu of the name appearing in the Undertakings. ANZ was not obliged to enquire into the background giving rise to the error of identification, which was not evident from the Undertakings themselves*."[6]

Rectification

For relief by rectification, it must be demonstrated that, at the time of the execution of the written instrument sought to be rectified, there was an "agreement" between the parties in the sense that the parties had a "common intention", and that the written instrument was to conform to that agreement.

Critically, it must also be demonstrated that the written instrument does not reflect the "agreement" because of a common mistake. There is no requirement for communication of that common intention by express statement but it must at least be the parties' actual intentions, viewed objectively from their words or actions, and must be correspondingly held by each party.

The Court held that the evidence before the primary judge disclosed that all parties to the transaction intended that the Undertakings should enure to the benefit of the party with which Nebax entered into the Construction Contract. It was Mr Simic's intention, and, therefore, Nebax's intention, that the Undertakings should operate in favour of Nebax's counterparty to the Construction Contract. Similarly, it was Ms Hanna's understanding, and, therefore, ANZ's understanding, that the Undertakings were to be entered into in relation to the Construction Contract.[7]

As the primary judge found, Mr Simic, and, therefore, Nebax, made a further mistake in informing Ms Hanna of the name of Nebax's counterparty to the Construction Contract. Mr Simic erroneously stated that the name of the counterparty was "New South Wales Land & Housing Department Trading As Housing NSW ABN 45754121940". That error was repeated in the applications prepared by Ms Hanna and signed by Mr Simic. Ms Hanna, and therefore ANZ, then unwittingly perpetuated the mistake by including the name "New South Wales Land & Housing Department Trading As Housing NSW ABN 45754121940" as the name of the counterparty in the Undertakings produced pursuant to the applications.

Conclusion

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[6] Kiefel J at [31]
[7] French CJ at [15]-[17]; Kiefel J at [50]; Gageler, Nettle & Gordon JJ at [107]-[109]

The orders made by the Court of Appeal were set aside and the Undertakings issued by ANZ were ordered to be rectified by substituting the words "New South Wales Land and Housing Corporation ABN 24 960 729 253" for the words "New South Wales Land & Housing Department Trading As Housing NSW ABN 45754121940".

The principle of strict compliance means that it is not possible as a matter of construction to refer to the underlying contract to determine the identity of a party, the manner in which the bond was intended to operate or the validity or enforceability of the bond itself at least as between the issuer of a bond and the beneficiary or favouree. The issuer's sole concern is to provide security in accordance with its contract with its customer and, when the security is issued, to see whether there has occurred the event stipulated in the instrument on which the issuer's obligation to pay arises.

Further, the principle of autonomy reflects that performance bonds, of their nature stand alone. That principle dictates that the surrounding circumstances and commercial purpose of the contract underlying the performance bond are different from those of the Undertakings and, accordingly, irrelevant to and not admissible on the question of construction of the performance bond itself.

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