

“On demand” performance bonds: no strings attached?

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A recent Australian case decided that a claim used as a basis for encashing an “on demand” performance security did not need to be authoritatively determined first.

Performance securities, which include performance bonds, are used on construction projects as a means of protection against a party’s non-performance of the terms of the contract. A performance security is typically an undertaking by the issuer (e.g. a bank) to pay a specified amount to a named beneficiary if the primary obligor fails to perform its obligations under the construction contract in question.

As the recent case of CPB Contractors Pty Ltd v JKC Australia LNG Pty Ltd [No 2] [2017] WASCA 123 demonstrates, where the performance security is “on demand” and otherwise unconditional, typically the beneficiary can encash the performance security without having first authoritatively determined the existence of its entitlement to make a demand.

Key facts

The key facts of CPB v JKC were as follows:

- CPB was employed by JKC as subcontractor to perform engineering procurement, construction and commissioning works associated with the Ichthys LNG Project in the Timor Sea. Pursuant to the terms of the subcontract, CPB procured “on demand” performance bonds from a bank totalling AUD\$26.1million in favour of JKC.
- JKC alleged that CPB failed to achieve the contractual completion dates, and that CPB was therefore liable to pay the maximum amount of liquidated damages under the subcontract, being an amount of over AUD\$39million.
- JKC intimated that it may have recourse against the performance bonds as a means of being paid those liquidated damages.
- CPB contested JKC’s claim, and pre-emptively commenced court proceedings, seeking an injunction to stop JKC from demanding or receiving payment from the bank under the performance bonds.

Recourse against the performance bonds

The performance bonds themselves were expressed in unconditional, “on demand” language, which placed no restrictions on when JKC could make a demand for payment. By contrast, the subcontract between JKC and CPB addressed the circumstances in which JKC could have recourse against the bonds. GC 35.3(a) of the subcontract provided in this regard that:

“[JKC] may have recourse to the Bank Guarantee(s) at any time in order to recover any amounts that are payable by [CPB] to [JKC] on demand.”

CPB argued that an amount is only “payable” for the purposes of GC 35.3(a) if objectively and undisputedly CPB had a contractual obligation to pay that amount. On CPB’s construction, no amount would be payable within the meaning of GC 35.3(a) unless JKC’s claim for liquidated damages had been determined through arbitration. CPB further alleged that GC 35.3(a) should be construed as serving the sole purpose of the protection of the contractor against the risk of insolvency of the subcontractor.

CPB’s interpretation was rejected by the Western Australia Court of Appeal. The Court considered the provisions of the subcontract and the performance bonds and determined that, providing GC 35(a) was exercised honestly and for proper purposes, JKC’s right to encash the performance bonds was a ‘right’ or ‘remedy’ given to JKC by CPB; was exercisable ‘at any time’ and was not expressed to be conditional upon either an admission of liability by CPB or an arbitral award; and did not require prior notice to be given to CPB.

Performance Security under the FIDIC Red Book

GC 35.3(a) of the CPB subcontract positively entitled JKC to make a demand on the performance security at any time. By contrast, General Condition 4.2 (*Performance Security*) of the FIDIC Redbook expressly prohibits the encashment of a performance security unless certain circumstances exist. GC 4.2 provides relevantly that:

“...[t]he Employer shall not make a claim under the Performance Security, except...in the event of:

...

- (b) *failure by the Contractor to pay the Employer an amount due, as either agreed by the Contractor or determined under Sub-Clause 2.5 [Employer’s Claims] or Clause 20 [Claims, Disputes and Arbitration], within 42 days after this agreement or determination;*
- (c) *failure by the Contractor to remedy a default within 42 days after receiving the Employer’s notice requiring the default to be remedied; or*
- (d) *circumstances which entitle the Employer to termination under Sub-Clause 15.2 [Termination by Employer], irrespective of whether notice of termination has been given.”*

An Employer must therefore be reasonably confident that identifiable circumstances exist which justify it seeking to encash a Performance Security under GC 4.2. Notably, however, there is no requirement under the FIDIC Red Book for the Employer to obtain an authoritative determination, for example from an arbitral tribunal, that it is entitled to encash the Performance Security as a precondition to *then* encashing it.

Conclusion

The legal treatment of “on demand” performance securities will differ depending on the wording of the contractual provisions concerning encashment. Demands on performance securities are usually made when the beneficiary of the security believes that its contracting counterparty is in default, whereas the counterparty may take the position that it has not committed any relevant default to justify a demand on the security. Courts and tribunals often face difficulties when trying to deal with urgent injunction applications to stop demands on performance bonds from being made or allowed to proceed, as it is often not entirely clear as to which party is right.

A perceived benefit of unconditional, “on demand” performance securities is that they can be encashed on an almost “no questions asked” basis. However, construction contracts often use controlling devices to define the purpose of the security and to curb abusive calls on them. As CPB v JKC illustrates, many courts are unwilling to intervene in contested demands on performance securities unless it is clear that the beneficiary of the security has no entitlement to encash it.

As a final matter, it is understood that an application to appeal CPB v JKC to the High Court of Australia (Australia’s highest court) will be made.

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