

## CASE NOTE

## Performance Guarantees

## Clough Engineering Ltd v Oil and Natural Gas Corporation Ltd [2008] FCAFC 136 (22 July 2008)

This case highlights the need to properly and clearly draft performance guarantees.

**Facts**

Clough Engineering Ltd entered into a contract with Oil and Natural Gas Corporation Ltd [ONGC] for the development of oil and gas fields off the coast of India and the construction of onshore facilities.

Under the contract Clough provided three bank guarantees to ONGC.

ONGC had the right to invoke the performance guarantees provided by Clough "in the event of the contractor failing to honour any of the commitments entered into under the contract."

Disputes arose between Clough and ONGC.

ONGC terminated the contract and made demands on the banks for payment under the guarantees.

Clough applied for an injunction to restrain ONGC from making a demand for payment under the guarantees and also restraining the banks from making payment to ONGC.

Clough argued that it was entitled to the injunction on the basis that there was a genuine dispute between the parties as to whether it was in default under the contract. Clough also argued that if it was in breach then this was a result of the failure by ONGC to perform.

The application for the injunction was unsuccessful and Clough appealed to the Federal Court.

**Key Issues**

On appeal key issues in the proceedings were:

1. whether on a strict interpretation of the contract, ONGC was entitled to call on the bank guarantees solely on the condition of a bona fide claim that Clough had failed to honor commitments under the contract

2. Whether ONGC acted unconscionably in calling on the guarantees.

**General Principles**

The Court considered the decision of the High Court in *Wood Ltd v The Pipeline Authority [1979]* HCA 21 which observed that the commercial purpose of guarantees was that they were equivalent to cash and that the introduction of a qualification on the entitlement to call on the guarantees would deprive them of their quality which given them commercial currency.

The Court however said that a court may prevent a party from calling on a performance guarantee if:

1. the party in whose favour the performance guarantee has been given has acted fraudulently.
2. the party in whose favour the performance guarantee has been given acted unconscionably in breach of section 51AA of the Trade Practices Act.
3. where the contract contains some qualification on the right to call on the performance guarantee.

**Proper construction of contract and guarantee**

As to the third exception, the Full Court held that the contract did not require an actual breach to be established before there was an entitlement to call on the performance guarantee.

According to the decision, "clear words will be required to support a construction which inhibits a beneficiary from calling on a performance guarantee where a breach is alleged in good faith ie non fraudulently."

On a proper construction of the contract when read together with the performance guarantee, the Court held that "ONGC was entitled to invoke the guarantee notwithstanding the existence of a dispute between Clough and ONGC as to



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whether Clough has failed to honor any of its commitments under the Contract...” [94]

At paragraph [99] the Court said:

“the terms of clause 3.3 of the Contract read together with clause 2 of the guarantee show that the commercial purpose of the Contract was to allocate the risk of who should be out of pocket notwithstanding that there may be a genuine dispute as to whether Clough had failed to honour commitments under the Contract. The risk was allocated to Clough there being no clear words to inhibit ONGC as the beneficiary of the guarantee from invoking it...”

#### **Unconscionable conduct.**

Given the unconditional nature of the guarantees and their commercial purpose and assuming the absence of any fraud the Court found that “there would seem to be very little if any scope for the application of equitable doctrines of unconscionable conduct to restrain the exercise by a party of its legal rights under such guarantees.”

The Court did however recognize that there may be extreme cases of bad faith exercises of power but that this was not such a case.

#### **Lessons to learn from Decision**

The decision identifies the dangers of an unconditional guarantee.

Although Clough argued that it was not in default and in the alternative that any default was due to a lack of performance by ONGC, the Court concluded that because the guarantees were unconditional, ONGC was in the absence of any inhibiting words entitled to call upon the guarantees.

To protect against this risk, contractors should carefully negotiate the conditions for the calling of their performance guarantees.

*If you would like any further information on this topic, please contact David Glinatsis on 8239 6502 or [david.glinatsis@kreissonlegal.com.au](mailto:david.glinatsis@kreissonlegal.com.au)*



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