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Editors: Dr Alan L Tyree and John Sheahan QC

THE GOVERNING PRINCIPLES OF INTERPRETATION OF PERFORMANCE GUARANTEES – *SIMIC v NEW SOUTH WALES LAND AND HOUSING CORPORATION* [2016] HCA 47

Thanuja Rodrigo*

Performance guarantees are security instruments issued by banks and other financial institutions. These security instruments are important in a wide variety of domestic and international commercial contracts such as building construction, energy industry and export trade. This case note examines the significance of the principles of autonomy and strict compliance in the interpretation of demands under performance guarantees.

INTRODUCTION

Performance guarantees are generally issued as a security device to reduce the risk of non-performance or defective performance of a contractual obligation. A bank that issues a performance guarantee is obliged to pay upon a demand that complies with the terms of the guarantee, usually production of a written demand by a named beneficiary. Therefore, a performance guarantee can be treated as an undertaking to pay on a written demand by the beneficiary, independent of any underlying contractual obligations. For that reason a performance guarantee stands “on a similar footing to” a letter of credit.¹ Therefore, the principles governing the legal effect and operation of performance guarantees are similar to those applicable to letters of credit.²

Performance guarantees and letters of credit are governed by the principle of strict compliance and the principle of autonomy.

The Principle of Strict Compliance

The principle of strict compliance denotes that the documents (such as a letter of demand for payment) tendered by the beneficiary to the paying bank must comply strictly with the terms of the letter of credit or guarantee. The House of Lords decision in *Equitable Trust Company of New York v Dawson Partners*³ has been considered as authority on the strict compliance rule under English law. Viscount Sumner speaking for the House of Lords said:

There is no room for documents which are almost the same, or which will do just as well. Business could not proceed securely on any other lines. The bank’s branch abroad, which knows nothing officially of the details of the transaction thus financed, cannot take upon itself to decide what will do well enough and what will not. If it does as it is told, it is safe; if it declines to do anything else, it is safe; if it departs from the conditions laid down; it acts at its own risk.⁴

This classic statement of Viscount Sumner indicates in ample measure that English common law has insisted the application of strict compliance in that the description in all the documents should be exactly the same as that of the credit instructions. In the examination of the documents a banker is not concerned as to whether the documents for which the buyer has stipulated serve any useful

* PhD (Griffith), LLM (Wales), Lecturer, Griffith University.

¹ Note that letters of credit are usually used as a payment mechanism to reduce the risk of non-payment for goods sent to a buyer. A bank is obliged to pay under a letter of credit upon tender of documents specified in the credit, and regardless of any dispute between the seller and buyer under the contract of sale. See generally, Nelson Enonchong, *The Independence Principle of Letters of Credit and Demand Guarantees* (Oxford University Press, 2011).

² See *Edward Owen Engineering Ltd v Barclays Bank International Ltd* [1978] QB 159; [1978] 1 Lloyd’s Rep 166, 172 (quoted with approval in *Wood Hall Ltd v Pipeline Authority* (1979) 141 CLR 443, 457–458; 53 ALJR 487).

³ *Equitable Trust Company of New York v Dawson Partners* (1927) 27 Lloyd’s L Rep 49.

⁴ *Equitable Trust Company of New York v Dawson Partners* (1927) 27 Lloyd’s L Rep 49, 52.

commercial purpose, or as to why the customer called for tender of a document of a particular description. A bank is also under no duty to know the trade customs and trade terms of its customers.

However, the courts have recognised limitations on the scope of the principle of strict compliance. For example, obvious spelling errors are not a valid ground for rejection of a demand for payment. In recognising limitations on the scope of this principle, courts have stated that:

[T]he requirement of strict compliance is not equivalent to a test of exact literal compliance in all circumstances and as regards all documents. To some extent, therefore, the banker must exercise his own judgment whether the requirement is satisfied by the documents presented to him.⁵

The Principle of Autonomy

Prior to the 1960s, the general rule was that a contract made by a letter of credit or performance guarantee was a contract between a bank and a seller, and this contract was completely separate from the contract between buyer and seller, so that even if nothing (or even substandard goods) was shipped by the seller in fulfilment of the contract for sale, the buyer could not prevent the bank from paying the seller. This was an absolute rule. The principle of autonomy which denotes this separation of the financial institution's payment obligation under the letter of credit or guarantee from the performance of the contractual obligations under the underlying contract is enshrined in the judicial thinking. In *Edward Owen Engineering Ltd v Barclays Bank International Ltd*⁶ Lord Denning described the performance guarantee as standing "on a similar footing to a letter of credit. A bank which gives a performance guarantee must honour that guarantee according to its terms. ... must pay according to its guarantee, on demand, if so stipulated, without proof or conditions".⁷

Courts have supported the view that the courts should be slow to intervene with the irrevocable commitments of banks because they are the "life blood of international commerce".⁸ However, the Australian courts have recognised the need for intervention in the enforcement of letters of credit and performance guarantees in limited circumstances where the payment under the letter of credit or performance guarantee was an abuse of that instrument, specifically in circumstances where the beneficiary has acted fraudulently or unconscionably.⁹

BRIEF FACTS AND LITIGATION HISTORY

Nebax Constructions Pty Ltd (Nebax) entered into a construction contract with New South Wales Land and Housing Corporation (the Corporation), and as security for performance of the contract Nebax provided two performance guarantees. At the request of Nebax (the applicant), Australia and New Zealand Banking Group Ltd (ANZ) (the issuer) issued these two performance guarantees in favour of "New South Wales Land & Housing Department trading as Housing NSW ABN 45 754 121 940" (the beneficiary). These guarantees were payable on written demand. Nebax agreed to indemnify ANZ against any loss, costs or expenses that it might incur in making any payment or that may arise from any claim on it, under the guarantees. The obligations of Nebax to ANZ were guaranteed by the appellant, Simic who was a director of Nebax. The guarantees came to identify the beneficiary of the guarantees as they did because of the instructions given by Simic to ANZ. Subsequently, New South Wales Land and Housing Corporation ABN 24 960 729 253, made a demand on ANZ for payment under the guarantees. ANZ declined to honour the demand on the basis that they had not been made by the beneficiary named in the guarantees.

⁵ *Karaganda Ltd v Midland Bank plc* [1999] 1 All ER (Comm) 801, 806.

⁶ *Edward Owen Engineering Ltd v Barclays Bank International Ltd* [1978] QB 159; [1978] 1 All ER 976.

⁷ *Edward Owen Engineering Ltd v Barclays Bank International Ltd* [1978] QB 159; [1978] 1 All ER 976, 983.

⁸ See the oft quoted statement of Kerr J in *RD Harbottle (Mercantile) Ltd v National Westminster Bank Ltd* [1978] QB 146; [1977] 2 All ER 862, 870 that irrevocable obligations assumed by banks are the life-blood of international commerce.

⁹ See generally, Thanuja Rodrigo, *Demand Guarantees: Operation, Enforcement and the Autonomy Principle* (LexisNexis, 2015). Note that Australian courts have also recognised breach of a negative stipulation in the contract that the beneficiary will not call upon the guarantee as a reason for granting injunctions restraining the enforcement of a performance guarantee. See generally, Thanuja Rodrigo, "Injunctions Restraining the Enforcement of Letters of Credit and Performance Guarantees: The Australian Experience" (2016) 44(6) ABLR 404.

The primary judge of the Supreme Court of New South Wales held that the case was a clear case where the literal meaning of the contractual words was an absurdity and that it was self-evident what the objective intention was to be taken to have been. His Honour considered that it was an absurdity because the literal description of the beneficiary named in the guarantee referred to a non-existent entity, with the result that none of those guarantees had any legal effect. His Honour also stated that it was self-evident from the language of the indemnity and the guarantees that the objective intention of Nebax and ANZ was that the party with which Nebax had entered into the construction contract was intended to be the entity referred to in the guarantees as beneficiary.¹⁰

The Court of Appeal¹¹ considered the question whether the primary judge failed to apply the principle of strict compliance and autonomy in the construction of the demand for payment under the guarantee.¹²

Firstly the Court of Appeal considered whether the principle of strict compliance is one of performance or one of construction. The Court of Appeal stated that the primary judge was correct to hold that the principle of strict compliance is properly classified as one of performance, because it is directed to the question whether documents tendered conform to the requirements stipulated by the letter of credit. In other words, it makes conceptual sense to consider the principle of strict compliance as one pertaining to performance. That is to say, the principle applies when considering the question whether a document tendered in purported pursuance of a letter of credit complies with the requirements imposed by it, after the letter of credit has been construed.

Secondly, the Court of Appeal considered whether the principle of autonomy is one of performance or one of construction. The autonomy principle restricts the range of material in the context of which a letter of credit or guarantee may be understood. Therefore, the Court of Appeal was of the view that the principle of autonomy must necessarily form part of the process of construction. The question was then whether the autonomy principle applied in the present case to prevent regard being had to the correct description of the beneficiary in the Construction Contract.¹³ The Court of Appeal was of the view that “similarly to the principle of strict compliance, the scope of the autonomy principle is not necessarily applied with unyielding exactitude in all cases”.¹⁴ Therefore, the Court of Appeal was of the view that it was permissible to have regard to the underlying contract to that extent

¹⁰ *New South Wales Land and Housing Corporation v Australia and New Zealand Banking Group Ltd* [2015] NSWSC 176, [78]. The primary judge made a declaration that the description of the beneficiary of the guarantees should be construed as describing the Corporation – a declaration that the term “New South Wales Land & Housing Department trading as Housing NSW ABN 45754121940” in the description of the beneficiary in the guarantees meant the Corporation. That conclusion was reached as a matter of the construction of that term. The primary judge stated that the guarantees may be rectified by substituting the name of the Corporation for the description of the beneficiary. The primary judge also made an order that ANZ was entitled to be indemnified by Nebax for the amount stated in the guarantees and also made declarations that the Guarantors, Simic were liable to ANZ under the various surety and guarantee agreements between the Guarantors and ANZ. Simic appealed to the Court of Appeal and asked for orders that the Corporation repay the amount under the guarantee (plus interest) to ANZ and that ANZ repay that amount to Simic.

¹¹ *Simic v New South Wales Land and Housing Corporation* [2015] NSWCA 413.

¹² In outlining these principles the Court of Appeal noted the following passage in *Griffin Energy Group Pty Ltd v ICICI Bank Ltd* [2015] NSWCA 29, [47]: “Secondly, both the Sale Agreement and Letters of Credit must be construed by reference to what a reasonable business person would have understood the terms to mean. Subject to the principle stated in the previous paragraph, this requires consideration of the language used by the parties, the surrounding circumstances known to them and the commercial purpose or objects to be secured by the contract: *Electricity Corporation v Woodside Energy Ltd* [2014] HCA 7; 251 CLR 640 at [35] (French CJ, Hayne, Crennan and Kiefel JJ). It is to be noted that the language, surrounding circumstances and commercial purpose or objects of the Sale Agreement are different from those of the Letters of Credit.” See *Simic v New South Wales Land and Housing Corporation* [2015] NSWCA 413, [91].

¹³ *Simic v New South Wales Land and Housing Corporation* [2015] NSWCA 413, [106]. The Court of Appeal stated that there is a difference between, on the one hand, construing a performance guarantee with reference to the terms of the underlying contract (ie, with reference to the rights and liabilities of the parties thereto), and, on the other hand, construing such an instrument with reference to the mere identification of that underlying contract, particularly where that contract is already identified in the instrument itself. Thus, it may be a reasonable application of the autonomy principle to state that regard may be had to an extrinsic document only to the extent to which it is referred to in the instrument.

¹⁴ *Simic v New South Wales Land and Housing Corporation* [2015] NSWCA 413, [91]. The Court of Appeal also noted (at [113]) that if there are two ways of reading or construing the guarantees, one of which means that the guarantees are quite

in order to determine the correct construction of the guarantees. Thus, the Court of Appeal held that the primary judge made no error in concluding that, on the proper construction of the guarantees, the words “New South Wales Land & Housing Department trading as Housing NSW ABN 45 754 121 940” meant the Corporation.

THE HIGH COURT DECISION

The High Court decision provides guidance in the application of the principles relevant to the proper construction of a performance guarantee, and explains the interrelationship between ordinary principles of contract law, and principles of autonomy and strict compliance which are peculiar to performance guarantees and letters of credit.

The specific construction question raised in the High Court was whether it was possible to construe the guarantees as being in favour of the Corporation instead of a named beneficiary that did not exist. With reference to the principles of strict compliance and autonomy, the High Court noted that these principles require that the party making a demand on a performance guarantee be the party named in the guarantee as the beneficiary and that any conditions on payment set out in the guarantee are satisfied.

Where a performance bond is expressed, as in the present case, to be unconditional, strict compliance at least requires that the beneficiary making demand for payment be the beneficiary named in the bond. Unlike the autonomy principle, it is not a rule of construction of the bond.¹⁵

On the construction issue the High Court noted that the name of the non-existent government department specified in the guarantees could not be construed by reference to underlying facts, requiring inquiry by the issuing bank, as a reference to the Corporation.¹⁶ Such a reference to the underlying contract could have been made if the beneficiary’s conduct in calling upon the guarantee was fraudulent or unconscionable or in breach of a contractual promise not to do so unless certain conditions were satisfied.¹⁷ The reason for this approach is that a loose approach to construction of performance guarantees would be inconsistent with the commercial purposes of the performance guarantees as security instruments.

Parties entering into a performance guarantee contract intend that if the beneficiary makes a compliant demand under the guarantee the bank will honour that demand without further investigation and/or reference to the underlying contract. In other words, by entering into a performance guarantee contract the parties intend to create a commercial result – provide a reliable security mechanism against non-performance or inadequate performance of a contract.

In construing the guarantees, the High Court referred to the ordinary principles of contract construction – the proper construction of each guarantee is to be determined objectively by reference to its text, context and purpose.¹⁸ It can be argued that the application of the ordinary principles of

ineffective because they are addressed to a non-existent entity, and one of which gives them the effect that, on their face, they are clearly intended to have, namely, as a facility for the beneficiary to demand payment of a sum of money from ANZ, the latter construction must be adopted.

¹⁵ *Simic v New South Wales Land and Housing Corporation* (2016) 91 ALJR 108; [2016] HCA 47, [7] (French CJ).

¹⁶ On the construction issue Kiefel J stated that: “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.” *Simic v New South Wales Land and Housing Corporation* (2016) 91 ALJR 108; [2016] HCA 47, [31] (Kiefel J). The issuer’s contractual obligation to honour a compliant demand under a performance guarantee was also reiterated by Gageler, Nettle and Gordon JJ at [85].

¹⁷ See generally, Rodrigo, n 9.

¹⁸ *Simic v New South Wales Land and Housing Corporation* (2016) 91 ALJR 108; [2016] HCA 47, [78] (Gageler, Nettle and Gordon JJ). In *Electricity Generation Corporation t/as Verve Energy v Woodside Energy Ltd* (2014) 251 CLR 640; 88 ALJR 447; [2014] HCA 7, [35] the High Court stated that: “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. That approach is not unfamiliar. As reaffirmed, it will require consideration of the language used by the parties, the surrounding circumstances 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

contract interpretation requires a court to take into consideration the commercial purpose of performance guarantees in construing such guarantees. Performance guarantees operate as instruments subject to prompt and inevitable payment if the beneficiary makes a demand on them. This inevitability and reliability is the reason for this instrument being referred to as equivalent to “cash in hand”.¹⁹

Thus, it is to be noted that the operation of the principle of autonomy is significant because it ensures the commercial efficacy of performance guarantees. The principle of autonomy also allows the financial institution to honour its financial commitments to the beneficiary, so as to ensure that there will be no effect on the financial institution’s “reputation for financial and contractual probity”.²⁰

With reference to the principle of strict compliance the High Court noted that:²¹

[T]he principle of strict compliance applies after the instrument has been construed, and it is not a rigid rule. It must be applied intelligently, not mechanically; the issuer must exercise its own judgment about whether the requirements stipulated in the instrument have been satisfied.

The demand under the guarantees in this case did not comply with the guarantees. The discrepancies and errors were not minor or merely typographical.²² The High Court concluded that consistent with the principle of strict compliance, it was not possible for ANZ to accept a demand from the Corporation and hence the definition of beneficiary in each guarantee should not be construed as referring to the Corporation. That is, the words “New South Wales Land & Housing Department trading as Housing NSW ABN 45 754 121 940” could not be construed to mean the Corporation. However, the performance guarantees were allowed to be rectified to reflect the common intention of the issuer and the applicant of the guarantee that the beneficiary be the party named in the underlying construction contract.

CONCLUDING REMARKS

The High Court in *Simic v New South Wales Land and Housing Corporation*²³ examined the judicial approach to construction of a demand under a performance guarantee. In particular, the High Court set out the proper approach to the interpretation of a demand under a performance guarantee where the erroneously named beneficiary is a non-existent entity. The High Court unanimously concluded that the bank is entitled to be satisfied that the beneficiary purporting to make a demand under a guarantee is in fact the beneficiary to which it is addressed, however, the bank has no duty to investigate matters relating to the underlying contract such as an investigation into the identity of the beneficiary.

an understanding ‘of the genesis of the transaction, the background, the context [and] the market in which the parties are operating’. As Arden LJ observed in *Re Golden Key Ltd*, unless a contrary intention is indicated, a court is entitled to approach the task of giving a commercial contract a businesslike interpretation on the assumption ‘that the parties ... intended to produce a commercial result’. A commercial contract is to be construed so as to avoid it ‘making commercial nonsense or working commercial inconvenience.’” For a discussion of rules relating to construction of contracts, see Jeannie Paterson, Andrew Robertson and Arlen Duke, *Principles of Contract Law* (Thomson Reuters, 5th ed, 2015) 315.

¹⁹ In the Australian case of *Wood Hall Ltd v Pipeline Authority* (1979) 141 CLR 443, 457; 53 ALJR 487, Stephen J observed the significance of performance guarantees operating as an instrument similar to cash in hand: “Once a document of this character ceases to be the equivalent of a cash payment, being instantly and unconditionally convertible to cash, it necessarily loses acceptability. Only so long as it is ‘as good as cash’ can it fulfil its useful purpose of affording to those to whom it is issued the advantages of cash while involving for those who procure its issue neither the loss of use of an equivalent money sum nor the interest charges which would be incurred if such a sum were to be borrowed for the purpose. Being ‘as good as cash’ in the eyes of those to whom it is issued is essential to its function.”

²⁰ *Bolivinter Oil SA v Chase Manhattan Bank NA* [1984] 1 WLR 392; [1984] 1 Lloyd’s Rep 251. Emphasising the importance of protecting the financial institutions that issue performance guarantees, Kerr J in *RD Harbottle (Mercantile) Ltd v National Westminster Bank Ltd* [1978] QB 146, 151; [1977] 2 All ER 862 said that “the bank had given its own guarantee and in effect pledged its own credit to the Egyptian bank to pay on demand. Its reputation depends on strict compliance with its obligations. This has always been an essential feature of banking practice.”

²¹ *Simic v New South Wales Land and Housing Corporation* (2016) 91 ALJR 108; [2016] HCA 47, [99] (Gageler, Nettle and Gordon JJ).

²² Note that it is common practice for banks, in a situation of apparent minor discrepancy, to approach the applicant for the credit or guarantee to ask whether it would be prepared to waive the discrepancy.

²³ *Simic v New South Wales Land and Housing Corporation* (2016) 91 ALJR 108; [2016] HCA 47.

The High Court's approach to interpretation of the performance guarantees reiterates the significance of the autonomy principle which prevents a banker undertaking an investigation into the matters relating to the underlying contract. An issuer's obligation cannot be determined by reference to an underlying contract. An issuer is contractually bound to follow the instructions of the applicant of the guarantee. Therefore, even if an applicant has provided incorrect information relating to the identity of the beneficiary of the guarantee, the issuer is contractually bound to honour the guarantee only to the named beneficiary. An issuer cannot be expected to interpret the named beneficiary as another entity and/or investigate into the correct identity of the beneficiary with reference to the underlying contract between the beneficiary and the applicant. This approach to interpretation of the performance guarantee is also consistent with the principle of strict compliance which is fundamental to the efficacy and dependability of performance guarantees as banking instruments.