

CONSTRUCTION BONDS - WHY RELEASING CAN BE FAR FROM SIMPLE

By James Dow & Katie Shorter

The importance of having clear provisions in construction contracts regarding the circumstances where a Principal may call up a contractor's bond was highlighted in the recent High Court decision of *Arrow International (NZ) Limited (In liq) & Ors v NZ Project 29 Limited & AAI Limited (formerly Vero)* [2019] NZHC 1326. The case involved an application made by contractor Arrow International (NZ) Limited (in liquidation) (**Arrow**) to extend an interim injunction that prevented AAI Ltd (**Vero**) from making payment to NZ Project 29 Ltd (**Project 29**) under a construction bond (Bond).

Key Facts

The Bond was issued by Vero in favour of Project 29 in association with a construction contract between Arrow and Project 29 for a property at 89 Courtney Place, Wellington (**Contract**). During construction, Arrow went into voluntary administration, causing construction works to cease. Project 29 then exercised its "step-in" right under the Contract to assume control of the works and resume possession of the construction site. Once Project 29 had resumed possession of the site, it exercised its right under the Contract to withhold further payments to Arrow and call on the Bond.

Arrow and its liquidators disputed that the claims made by Project 29 under the Bond were legitimate. Arrow applied to the High Court for orders to extend the interim injunction granted by the Court the month prior that prevented Vero from making payment to Project 29 under the Bond.

Decision

The Bond was conditional both via the Contract and the Bond itself. The Contract contained a clause providing that the Engineer was required to certify that Arrow had breached the Contract and then make a provisional assessment of all amounts

that may become owing to Project 29 by Arrow, before Project 29 was able to make a call on the Bond.

Arrow argued that the clause contemplates the Engineer making an assessment of the amount Project 29 would have paid to Arrow had Arrow completed the works under the Contract, against the amount Project 29 would have to pay to complete the works following Arrow's default. However, there was no calculation of such costs in the spreadsheet provided by the Engineer. The Court accepted this argument and found that without a direct assessment of the cost to complete the Contract works, the Engineer had not issued the certificate in accordance with the terms of the Contract.

The Bond also contained a clause that reinforced the obligations of the Engineer as a condition of a demand by Project 29 under the Bond. The clause stated that demand by Project 29 for the Bond must be accompanied by a certificate from the Engineer which certified that Arrow was in default under the Contract and that "the sum demanded is in the opinion of the Engineer reasonable having regards to the nature and consequence of the default".

The Court took issue with the Engineer's certification that the sum demanded by Project 29

was reasonable. The Court held that it was arguable that by not certifying the claim in accordance with the terms of the Contract, the Engineer had not met the terms of the Bond allowing Project 29 to issue a demand on Vero under the Bond.

However, for the Court to extend the period of the interim injunction, Arrow had to demonstrate that the contractual provisions were not given effect to and the Engineer's certificate was not valid under the Contract. While by failing to assess the cost of completion, the Engineer had not complied with the terms of the Contract and Bond, this did not mean the Engineer's certificate was invalid under the contractual machinery. The purpose of the Engineer's certificate was to relieve Project 29 from the adverse impacts of disputes. It would be inappropriate for the Court to transfer the risk of dispute back to Project 29.

The Court held that ultimately, it is not for them to make orders that are inconsistent with what the parties had contractually agreed would occur if

Arrow failed to fulfil its obligations under the Contract. The Contract expressly outlined that if Arrow failed to meet its contractual obligations, Project 29 had a right to "step-in" and resume possession of the site and call up the Bond. The Bond itself also stated that Vero was liable to release the Bond, irrespective of any dispute or disagreement between Arrow and Project 29.

The Court held there was no basis to continue the interim injunction and discharged the interim injunction in place.

Practical Considerations

Arrow is a timely reminder of the importance of parties including clear provisions regarding bonds (both in construction contracts and in bonds themselves). Wherever possible, the Courts will give effect to the intention of the contracting parties and the allocation of risk expressly negotiated by the parties, but this can be a lengthy process if the contract and bond are not clear.



In deciding what form of bond to use, principals should consider using on-demand bonds over conditional bonds. In Arrow, the Bond was a conditional bond, meaning there was only an obligation on Vero to release the Bond if certain conditions were met. Arrow's argument would have had no weight if the Bond had been a pure on-demand bond, as Vero would have had an absolute obligation to release the Bond, regardless of whether the Engineer had correctly certified the amounts owed.

Principals could also consider including a clause in their construction contracts and/or bonds that precludes the contractor from interfering with the principal recovering payment under a bond, by for example, applying for an injunction as in Arrow. In Arrow, the Court placed significant weight on the inclusion of a clause in the Contract and Bond that

provided that Vero was still liable to release the Bond to Project 29 regardless of any disagreement between Arrow and Project 29 as to the amount owed. The purpose of such a clause is to prevent principals from being disadvantaged from having access to a bond simply because the contractor, or the contractor's liquidator, disputes the amount owed.

It is also important to carefully consider what performance security should be in place when negotiating construction contracts. Bonds operate as a financial remedy only and will not remedy incomplete or deficient works. In appropriate circumstances, principals should consider whether a parent company guarantee should also be obtained in conjunction with a bond as a practical remedy in regards to performance.

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