

BONDS

8 July 2008

Our reference
MYR 02-1343-8573**1. Instructions**

1.1 Aussie Bonds Australia Pty Ltd (**ABAPL**) & Underwriting Australia Pty Ltd (UAPL) have asked us to:

- (a) confirm that the exemption in Regulation 7.1.07 of the *Corporations Act 2001* (Cth) applies to its bond products;
- (b) summarise the differences between surety bonds (conditional performance bonds) and bank guarantees (unconditional performance bonds); and
- (c) confirm why its bond products are not insurance.

2. FSR issues

2.1 Chapter 7 of the *Corporations Act 2001* (Cth) does not apply to surety bonds as defined in Regulation 7.1.07 of the *Corporations Regulations 2001* (Cth):

- "(1) This regulation applies to an arrangement between 2 persons (person 1 and person 2) made in the following circumstances:
 - (a) person 1 enters into the arrangement in order to meet a requirement of another arrangement between person 1 and a person other than person 2 (person 3);
 - (b) under the arrangement, person 2 undertakes to make a payment to, or perform an obligation for the benefit of, person 3 in circumstances specified as part of the arrangement;
 - (c) under the arrangement, person 1 is liable to person 2 for any payments made, or liabilities, costs or expenses incurred, by person 2 in making the payment to, or performing the obligation for the benefit of, person 3;
 - (d) the arrangement does not constitute a financial product under section 764A of the Act, other than a derivative.
- (2) For paragraph 765A (1) (y) of the Act, the arrangement is not a financial product."

2.2 Whilst sections 3 and 4 below look at the types of bonds more broadly, we have been provided with a Commercial Lease Bond which ABAPL & UAPL issue as agents for Lumley General Insurance Ltd (**Lumley**) and

a brochure describing the Commercial Lease Bond (**Brochure**). As we note throughout this memorandum, if other bonds, issued by ABAPL and UAPL are similarly structured, our comments equally apply.

- 2.3 The arrangement which the Commercial Lease Bond gives rise to satisfies the definition of Surety Bond under the regulation.
- 2.4 The lessee enters into the arrangement (the Commercial Lease Bond) in order to meet the requirement of another agreement (the Commercial Lease) between it (Person 1, the tenant) and a person other than Lumley (Person 2, the Surety Bond issuer) (the lessor, Person 3, the landlord) satisfying subparagraph (a).
- 2.5 Under the Commercial Lease Bond, Lumley undertakes to make a payment to the lessor in circumstances specified as part of the arrangement (when a demand is made) satisfying subparagraph (b).
- 2.6 According to the Brochure, under the Commercial Lease Bond, the lessee is liable to Lumley for any payments made, or liabilities, costs or expenses incurred, by Lumley in making the payment to the Lessor: subparagraph (c).
- 2.7 Subparagraph (d) is satisfied because the Commercial Lease Bond does not constitute a financial product under s764A or by importation, any regulations made for the purpose of that section (it may constitute a derivative, however this is immaterial for the purpose of the exemption).
- 2.8 Assuming the other bonds are structured in a similar way we believe they will fall under the exemption.

3. **Differences between Surety Bonds (conditional performance bonds) and bank guarantees (unconditional performance bonds)**

- 3.1 The definition of Surety Bond under the Corporations Act is a set of eligibility criteria which applies to an FSR exemption rather than a prescriptive statement of the type of product that constitutes a Surety Bond.

- 3.2 *Modern Contracts of Guarantee* describes a performance bond as follows:

"Performance bonds are a common mechanism in commercial transactions to protect against failure of a contracting party to perform. In the context of a contract for the sale of goods, a performance bond may secure the seller's obligation to deliver, or the buyer's obligation to pay the price. Similarly, in construction contracts, performance bonds are a means of guaranteeing the performance of the head contractor to the proprietor or, alternatively, the performance of a sub-contractor to the head-contractor."¹

- 3.3 There are two types of performance bonds:

- conditional – where the guarantor's liability (Person 2, the performance bond issuer) to pay the third party (Person 3) is triggered on proof of the principal's (Person 1's) default; and
- unconditional (or on-demand) – where the guarantor (Person 2, the performance bond issuer) is liable when it receives a demand on the bond (proof is not required).

¹ O'Donovan J and Philips J *Modern Contract of Guarantee* Thomson Law Book Co, Pyrmont, 2004 para 15.100

- 3.4 Surety Bonds are a type of conditional performance bond because the trigger for the payment by the guarantor or surety is the failure of the principal to meet its obligations under a contract.
- 3.5 Conditional performance bonds are a true type of guarantee at law and the principles of surety apply to them. This means the bond will *prima facie* be interpreted as co-extensive with the liability under the primary contract and:
- the bond will remain in force until the primary contract has been completed;
 - the bond issuer will be discharged by a release of principal by the third party or by a variation in the primary contract; or
 - the bond issuer may rely on a set-off or counter-claim possessed by the principal.
- 3.6 Bank guarantees are a type of unconditional performance bond as the bank will pay on demand rather than on proof of the default under the primary contract.
- 3.7 Unconditional performance bonds are not guarantees and the principles of surety do not apply to them.
- 3.8 In *Wood Hall Ltd v Pipeline Authority of Australia* (1979) 141 CLR 443 at 445 Barwick CJ stated:
- "The description "guarantee" commercially applied to the bank documents in this case is, in my opinion, a complete misnomer. The relationship of the bank to the owner or to the contractor has, in my opinion, none of the elements of suretyship. The circumstance that the purpose of the cash deposit or its documentary substitute is as a security for the due performance of the contract or the contract work does not, in my opinion, involve either the bank or the owner in any of the obligations or rights of suretyship. ...The bank documents are really in the nature of an unconditional bond to pay money on demand up to a stated maximum amount, the resolutive condition of the bond, other than payment, being expressed, for example, in cl 2 of the said deed."
- 3.9 The terms of the Commercial Lease Bond require a lessor's demand to be in writing, to be served on Lumley and to be accompanied by a written statement signed by the lessor advising Lumley of the demand. However, the Commercial Lease Bond does not stipulate that Lumley requires proof that the lessee has defaulted under the contract, only that a demand is made.
- 3.10 It is obviously an unconditional (or on demand) performance bond as no proof of the principal's default is required, rather than a surety bond or conditional performance bond.
- 3.11 Assuming ABAPL and UAPL's other Surety Bonds do not require proof of the underlying default they will also constitute unconditional performance bonds.
- 3.12 Because ABAPL and UAPL's bonds are more like a bank guarantee, than a surety bond, we will not summarise the differences between a surety bond (conditional performance bond) and a bank guarantee (unconditional performance bond), however some general differences between the Commercial Lease Bond and a Bank Guarantee are as follows:
- the lessee will not have to pledge any security (generally required in bank guarantees);
 - the Commercial Lease Bond may not appear as a balance sheet liability or impact on the availability of credit to the lessee (which a bank guarantee would do); and
 - if the application process involves Lumley assessing the financial robustness of the lessee, a lessor may perceive the lessee as having the ability to satisfy the lease

terms – a bank will not undertake this level of scrutiny provided securities are sufficient.

4. Insurance issue

- 4.1 We do not believe the performance bonds of the type issued by ABAPL and UAPL are insurance.
- 4.2 Despite our conclusion that the Commercial Lease Bonds are not a type of guarantee or surety bond, we believe the similarity between unconditional performance bonds and guarantees is significant enough that the factors used to distinguish guarantees from insurance will still apply.
- 4.3 The difference between guarantees and contracts of insurance are the nature of the contract, the obligations it creates and the way it is effected². Examples of the distinguishing factors are as follows:

Primary rather than collateral obligation

- 4.4 A contract of guarantee involves the creation of a collateral obligation to meet the demand of a third party on the default or debt of the principal. A contract of insurance on the other hand creates a primary liability between the insurer and the insured, generally to pay money upon the occurrence of an event.³
- 4.5 The Commercial Lease Bond represents a collateral obligation on the bond issuer to the Lessor.

Duty of utmost good faith and disclosure

- 4.6 In *Seaton v Heath* [1899] 1 QB 782 at 793 Romer LJ stated that a contract would be a guarantee rather than insurance if it did not contain a duty of utmost good faith (*uberrimae fides*) and if there was no duty of disclosure imposed on the insured.
- 4.7 His Honour also stated that in contracts of guarantee the surety was generally aware of the exact risk that it was exposed to and had the same knowledge of the risk as the debtor unlike a contract of insurance where the insured has a greater knowledge of the risk than the insurer and the contract involves a matter of speculation.
- 4.8 *The Zuhail K & Selin* [1987] 1 Lloyds Rep 151 the Queens Bench also considered that the failure of an insurance company to make any enquiry in regard to the risk of the contract was indicative of a guarantee rather than a contract of insurance.
- 4.9 The documentation that we have been provided with does not indicate that the Commercial Lease Bond is a contract *uberrimae fides*. It is common for surety bond issuers to make enquiries into the ability of the lessee to complete the lease (we have not seen the Commercial Lease Bond application), however this disclosure is less rigorous than the obligations imposed on potential insureds of contracts of insurance.

Right of recovery/counter indemnity

- 4.10 In *The Zuhail K* the contract was also found to be a guarantee because the agreement contained a counter indemnity which provided the guarantor with a right to recover any amounts paid under the guarantee from the debtor. Such a right would not be present in a contract of insurance as it would defeat the purpose of having the contract at all.

² Sutton K *Insurance Law in Australian* 3rd Ed LBC Information Services, Pymont, 1999 pg 10

³ *Modern Contract of Guarantee* op.cit para 1.1500

- 4.11 The Brochure that you have provided us with indicates that the lessee becomes liable to Lumley for all amounts payable in respect of the Commercial Lease Bond, plus interest and recovery costs.

Payment of the default rather than an indemnity

- 4.12 In a guarantee the promise is to make good the debtor's debt or default rather than to indemnify the debtor: *Dane v Mortgage Insurance Corp Ltd* [1894] 1 QB 54 at 60.
- 4.13 This is the case under the Commercial Lease Bond.

Positions of the contracting parties

- 4.14 In a contract of guarantee the parties occupy the positions of creditor, debtor and surety however in a contract of insurance the party who benefits under the contract applies to the party that will provide the benefit directly: *Seaton v Heath*. Contracts of guarantee do not involve the payment of a premium to the guarantor by the creditor.
- 4.15 The lessor, the lessee and Lumley appear to occupy these respective positions under the Commercial Lease Bond.

Insurable interest

- 4.16 The lack of an insurable interest in the subject matter will favour an argument that a particular contract is a guarantee rather than a contract of insurance, however this principle has been modified by the introduction of Section 16 of the *Insurance Contracts Act 1984* (Cth).
- 4.17 In light of these examples, we believe that the Commercial Lease Bond does not constitute a contract of insurance.

If you have any queries do not hesitate to call.

Blake Dawson