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Project security: bonds and guarantees

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Introduction

This paper considers some of the basic principles relating to bonds in the construction industry. By its nature, therefore, this paper briefly compares formal security to informal security such as bonds and guarantees before then examining unconditional on-demand bonds and conditional bonds.

Bonds and guarantees are basically a form of security. In other words, the financial protection that supports a contractual obligation. These forms of protection could be included as contract terms, however, it is more likely that they will be provided by a separate security agreement. Security against default can be provided by way of formal security, for example charges, mortgages, liens etc, and also by way of informal security. Informal security includes indemnity, collateral contract, suretyship (guarantees), demand bonds and insurance.

All of the informal forms of security arise by way of indemnity. It is therefore convenient to consider the nature of indemnity first before then considering the special characteristics of suretyship and insurance.

Indemnity

An indemnity is a primary obligation that can simply be included in a contract between two parties. It is a contract where the indemnifier keeps the beneficially "harmless against loss". The case of *Yeoman Credit v Latter* provides support for these simple principles.[1] The often archaic language of keeping "the other harmless against loss" is frequently encountered in contracts of indemnity, and their subspecies of suretyship and insurance. It was said in *Yeoman Credit* that in modern language an indemnity is:

> "An agreement by one person to keep the other entirely protected or immune against the kinds of liabilities set out in the document".

There are, therefore, three main features of indemnity. First, it is an original and independent obligation. The beneficiary is entitled to be paid regardless of the recoverability or position of any other person. Second, there is no need for the beneficiary to show who caused the loss or why or how the loss was caused. This is an important feature of indemnities. The beneficiary simply needs to show that the loss was caused and that it was the type of loss for which the indemnity was given. The beneficiary will then be able to recover. Finally, there is no need for the beneficiary to show that any loss recovered by them needs to be passed on to third parties.

Indemnities are frequently encountered in their most simplistic form in primary contractual obligations, but also in on demand bonds, demand guarantees, documentary bonds, stand by letters of credit, contracts of suretyship and insurance contracts. These latter two categories, of suretyship and of insurance are contracts of indemnity but with more refined or special characteristics. They are, therefore, a branch of indemnity.

1 [1961] 2 All ER 294

Contractual indemnities

A simple contractual indemnity is a primary obligation arising between two people. A simple indemnity clause might state that one party "agrees to indemnify you if you suffer damage as a result of my negligence". Contractual indemnities might also arise in the form of collateral contracts. These might simply be as a result of an assurance given which then induces a contract.

In terms of more frequently encountered security, we are concerned with formal contracts that are ancillary to the primary contract. Common forms of ancillary or collateral contract include collateral warranties (duty of care deeds) or direct step-in agreements given to funders. They could also include letters of intent or letters of comfort.

Insurance

It is worth mentioning insurance before moving on to consider suretyship and in particular bonds. This is because insurance is a type of indemnity contract. It arises from a primary obligation whereby the insurer indemnifies the insured against loss caused by a specified insurance risk. A breach of contract is not required in order for the insured to recover under the insurance policy. However, there are special characteristics of contracts of insurance, such as a duty of utmost good faith, and the requirement for the beneficiary to have an insurable interest.

Suretyship

A surety is a guarantor. A surety or guarantor is someone who contracts with an actual or potential creditor of another so as to be responsible to that creditor by way of security for all or part of the debt. The key characteristic of suretyship is that it is collateral to the main agreement, and is therefore a secondary obligation. A surety cannot be someone who has become liable in substitution for the liability of another. Neither can a surety be someone who has joint liability with another.

According to Halsbury's Laws:

> "A guarantee is an *accessory contract* by which the promisor undertakes to be answerable to the promisee for the *debt, default or miscarriage* of another person, whose primary liability to the promisee must exist or be contemplated."[2]

In other words, it's a secondary obligation or separate contract placing an obligation on a guarantor to ensure that the principal completes a certain task for a third party beneficiary. If the principal fails to carry out that task then it is the guarantor's obligation to perform the principal's task. If the guarantor fails, then the guarantor is liable in damages.

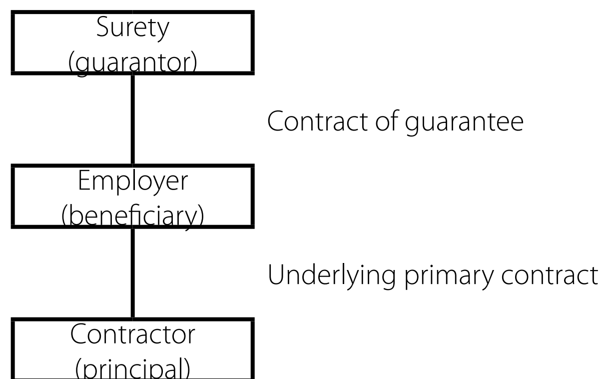
The liability of a surety or guarantor arises because a material fault has occurred under a primary underlying contract. This liability under the primary contract must arise before liability can arise under the second surety contract.

1 Halsbury's Laws, Fourth Edition, Volume 20. para 101.

The characteristics of suretyship are:

1. That there are two contracts. A contract of guarantee, and the underlying primary contract which is to be guaranteed.

2. That there are three parties. The guarantor, beneficiary and contractor. The guarantor and beneficiary are parties to the contract and the guarantee. The beneficiary and the contractor are parties to the underlying primary contract.



It is the guarantor's obligation to ensure that the principal performs the obligations being guaranteed. If the guarantor fails then the guarantor is liable in damages to the beneficiary. Therefore, the guarantor's primary duty to the beneficiary is to ensure that the principle contractor performs (by ensuring that the contractor performs or by the guarantor performing), and the second duty is to be liable in damages.

An important characteristic of suretyship is that it is not the guarantor's primary duty under the guarantee to pay damages, but to ensure the performance of the principal's obligations. A guarantor only becomes liable to the beneficiary if there is a breach of the principle or primary contract.[3]

Another point to note is that under suretyship the principal or contractor receives no benefit from the guarantee or the bond himself. This should be compared with contracts of insurance where the primary purpose of the insurance contract is to provide risk cover to the insured. While it is the contractor who takes out the bond the benefit of that bond is for another.

Demand bonds

According to Halsbury's Laws:

> "A bond is an instrument under seal whereby one person binds himself to another for the payment of a specified sum of money either immediately or at a fixed future date". [4]

A bond provides security for the beneficiary in the event that the principal fails to complete the contract and the principal is unable to recover its losses from the contractor. There is an important distinction between the types of bonds that are

3 Moschi v Lep Air Services Limited [1973] AC 331

4 Halsbury's Laws, 4th Edition. Volume 13, para 88

available. An *unconditional bond* is a primary obligation where the bondsman promises to pay a certain amount on receipt of a written demand. However, and in more frequent use in the construction industry are secondary obligations or *conditional bonds*. A variety of interchangeable names are given to bonds. These include:

Type of obligation	Name given to the Bond
Primary	single bond, simple bond, on demand bond (although bankers use the term "performance bond"), demand guarantee, documentary demand bond.
Secondary	conditional bond, surety bond, default bond.

Note the construction industry usually uses the term "performance bond" for a secondary obligation or conditional bond, while bankers understand the term "performance bond" to mean an on demand bond.

A primary or on demand bond is simply an undertaking for the bondsman to pay a sum of money without any condition. Simple forms of words are used, and it would be adequate to quite simply state:

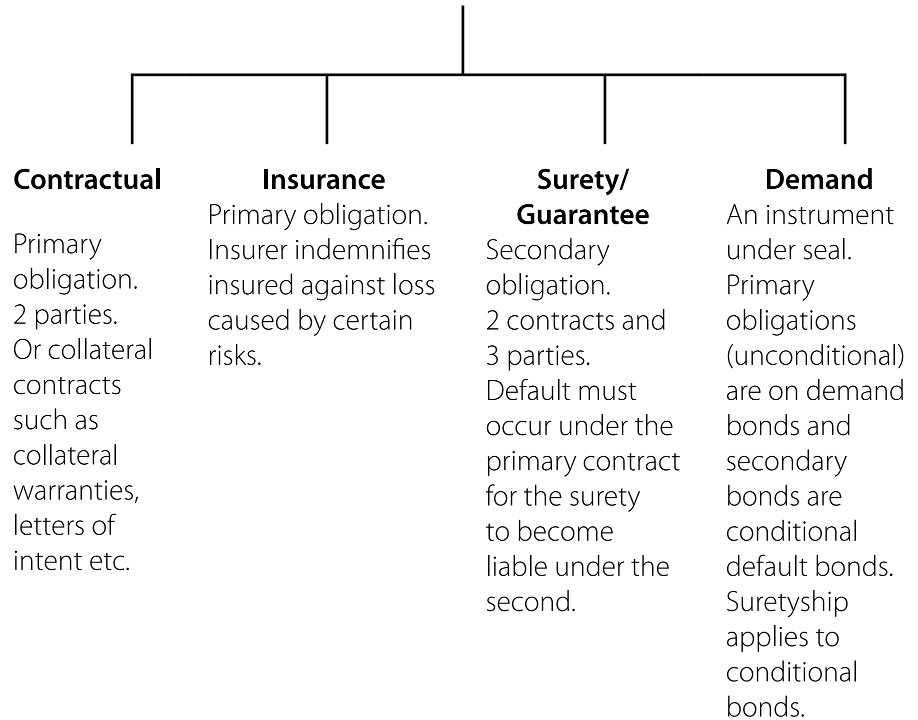
> "I promise to pay you £**XXX** on receipt of your written request."

However, in practice particular forms of wording have developed some of which have been in use for hundreds of years. Banks also often produce their own forms of standard on demand bonds.

A conditional bond (a secondary obligation bond) will consist of two parts. The first is an obligation to pay, and the second is the condition, which is in fact the real agreement between the parties. This is where the distinction between classic surety wording and bonds arises, although arguably conditional bonds are a form of surety.

The drafting for a surety arrangement might state that "If X does not perform I will pay you the £**XXX**", whereas a conditional bond would promise to pay a certain amount on the condition that if the bondsman performs his contract then the promise is void. The most frequently encountered bondsman's promise in the construction industry is to pay up to a maximum amount for actual losses that have been incurred for breach of contract (and frequently insolvency) that can be proved to have arisen under the primary construction contract.

In summary, the relationship between indemnity, and its species of contractual indemnity, insurance, surety and demand bonds can be set out in a simple diagram as follows:



Basic rules of suretyship

There are some important characteristics of the law of suretyship, which cover guarantees and also performance bonds. Richard Davis identifies four key characteristics in Emden,[5] while Richard Wilmott-Smith QC identifies 6 characteristics.[6] They have effectively identified the same points but analysed them from slightly different perspectives. These characteristics comprise:

1. Section 4 of the Statute of Frauds 1677 applies. Section 4 states:-

> "No action shall be brought whereby to charge the defendant upon any special promise to answer for the debt, default or miscarriage of another person … unless the agreement upon which such action shall be brought … *shall be in writing* and signed by the party to be charged therewith.." [Emphasis added]

A guarantee or bond must therefore be in writing and be executed by the guarantor or bondsman. In the absence of a signed agreement in writing it would not be possible to claim against the guarantor nor to request payment for a bondsman.

This point was recently emphasised in the case of *Actionstrength Ltd (trading as Vital Resources) v International Glass Engineering In.Gl En Spa and others*[7] where a sub-contractor sought direct payment from the employer after the contractor

5 Emden, Chapter 19 "Contract Guarantees and performance bonds", page 254.
6 R. Wilmott-Smith QC (2002) "Bonds and Guarantees", Construction Law Master Class, IBC, 4 November.
7 [2003] BLR 207

became insolvent. This was on the basis that the sub-contractor refused to carry out further work because of the potential pending insolvency of the contractor and would not have continued with the work but for the employer stating that he would see that the sub-contractor received payment.

The House of Lords held that an oral guarantee was unenforceable because it did not comply with section 4 of the Statute of Frauds 1677. Further, the promise to pay could not give rise to an estoppel preventing the defendant from relying on the statute. Only because the assurance was not reduced to writing did the Statute of the Fraud 1677 apply, and so the sub-contractor could not rely on the apparent oral guarantee.

2. Consideration must be present. There are many exceptions to the rule that consideration must be present. It was originally the case that consideration must be recorded in writing. However the Mercantile Law Amendment Act 1856 has amended that position and consideration need not be set out in writing. Further, while a guarantee requires consideration none is required in the case of bonds. In practice, this is one reason why bonds are preferred to simple guarantees. This is because no consideration passes from the bondsman to the employer because it is the contractor that pays for the bond.

3. Section 5 of the Mercantile Law Amendment Act 1856 also provides the surety with a right of subrogation. Section 5 provides that a surety has the right to have assigned to it every judgment or other security and to stand in place of the creditor and use the name of the creditor in any action in order to claim from the principal debtor any money advanced.

4. If the surety discharges the obligations then there is an implied indemnity against the debtor in favour of the surety. In most circumstances this is expressly set out in the document.

5. If there is a material variation to the principal contract then that variation will discharge the surety.[8]

6. The parole evidence rule is not admissible in order to extend the terms of the guarantee. The *contra proferentem* rule does apply and the guarantee will also be construed against the factual background. [9] However, also note that the courts have for many centuries tended to favour sureties and so construe guarantees favourably to the surety.[10]

In practice, the common law obligations placed upon the contractor in respect of the surety are dealt within an express counter indemnity.

In respect of these subrogated rights, the surety will be able to take action against the contractor to enforce performance of the contract or repay money paid by the surety. In practice this means that retention monies held by the employer will be available to the surety, rather than to the contactor.

8 Holme v Brunskill (1878) 3 QBD 495 at 505
9 Hyundai Shipbuilding and Heavy Industries Co Ltd v Pournaras [1978] 2 Lloyds LR 502 at 506
10 See I.N. Duncan Wallace in Hudson, and also Parker LJ in the Mercers case.

On-demand bonds and conditional bonds distinguished

There is a considerable difference between an on-demand and a conditional bond. An on-demand bond entitles the holder of the bond to demand payment from the bondsman by simply giving a notice in the form required under the bond. The bond usually only requires a mere assertion of default. The bond must be paid regardless whether there is a dispute about the underlying primary contract or indeed the reason for calling on the bond. An example of the operative wording of an on-demand bond is set out in the case of *Esal (Commodities) Limited v Oriental Credit Limited*: [11]

> "We undertake to pay the said amount on your written demand in the event that the supplier fails to execute the contract in perfect performance".

On the other hand, a conditional bond will only be paid once the loss or damage has been established.

The distinction is best illustrated in the leading case of *Trafalgar House Construction (Regions) Limited v General Surety & Guarantee Co Limited.*[12] In that case, the contractor had to establish loss before being able to claim under the bond. The bond was therefore a conditional bond. The bond was in a standard model form, which was considered by the lower courts to be an on-demand style bond but the House of Lords came to the firm conclusion that it was a conditional bond.

Maidstone Borough Council was the employer and they had engaged Trafalgar House as main contractor for the construction of a leisure complex. Trafalgar House then sub-contracted the groundwork to K.D. Chambers. At the same time they obtained a bond for 10% of the contract value. 10% equated to £101,285, and the bond cost £2,785. K.D. Chambers went into receivership. Trafalgar House then took over and completed the work and made a claim under the bond. The form of the bond was almost identical to that which appears in the Appendix to the ICE Conditions of Contract 5th Edition.

At first instance, the official referee decided that the damages sustained exceeded the amount of the bond and therefore awarded summary judgment for the full amount of the bond. He came the conclusion that there was prima facie evidence that the sub-contractor was in default and that the damage suffered by the main contractor had not been discharged by the bondsman. He did not enquire into the amount of those damages on the basis that it would be inconsistent with the commercial purpose and intent of the bond. Further, he considered that it was not necessary to look at any counterclaim or abatement to the principal debt.

The Court of Appeal approved payment because they came to the conclusion that the bond was an on-demand type of bond. This was because they found that the bond was not a guarantee and that the bondsman was obliged to pay the amount asserted in good faith by the contractor.

The Court of Appeal's conclusion was met with surprise by quite a number of legal commentators at the time.[13] It was of little surprise when the House of Lords reversed the decision coming to the firm conclusion that the bond was a guarantee and therefore

11 1985] 2 Lloyds RP 546
12 1996 AC 1999
13 For example see Wallace, I.D.N. (1994) "Loose Cannons in the Court of Appeal" 10 CLJ 190.

a breach of the underlying contract and damages had to be proved. The plaintiff, therefore, had to establish the damages caused by the breach and subject to the maximum amount of the bond could only recover the amount of damages proved. The bondsmen was also entitled to set-off and abatement.

It is this case which highlights the key distinguishing characteristics between a demand bond and a guarantee. An on-demand bond is an unconditional obligation to pay once a proper demand has been made. On the other hand a condition bond or performance guarantee requires certain conditions to be met before payment is to be made.

On-demand bonds

On-demand bonds are in the form of a primary undertaking to pay on demand, and not in the form of a guarantee that relies upon a breach of the underlying obligation. On-demand bonds are therefore very similar to letters of credit. This is because when a bank issues an on-demand bond or a letter of credit it is not concerned with the underlying transaction. It is now well established that, in the absence of fraud, a bank must pay an on-demand bond provided that the demand is in the form anticipated by the bond.

The banks that issue letters of credit and on-demand bonds will wish to protect their commercial reputations and so providing the documentary requirements set out in the bond are met they will make payment.

The operative provision of the bond might appear as follows:

> "The bank undertakes to pay the beneficiary on receipt of its first demand in writing ("A demand") on the bank stating that the Contractor is in breach of its obligations under the contract the sum of £XXX".

A "no proof" or "conclusive evidence" clause is frequently encountered in an on-demand bond. A typical clause will state:

> "The bank agrees that it will fulfil its obligation under this bond without proof or condition and have agreed that the receipt by the bank of the demand in accordance with the terms of this bond, such demand being conclusive evidence of the bank's liability to pay the beneficiary the sum set out in this bond.

The simple operation of these two clauses provides that the written demand stating that the contractor is in breach of contract from the beneficiary to the bank is conclusive evidence of the bank's liability to pay the beneficiary. The bank is, therefore, obliged to pay the beneficiary regardless of any argument, save for fraud, that the contractor might raise.

An example of an on-demand bond used in the construction industry is set out in the case of *Edward Owen Engineering Limited v Barclays Bank International Limited.*[14] The bond stated that it should be paid "on-demand bond without proof or conditions". Barclays Bank had provided the bond to an English supplier, Edward Owen Engineering. They in turn had contracted to supply goods to a Libyan customer.

14 1978] 1 QB 159 (CA)

The Libyan customer made a call on the bond when he himself was in default. Edwards Owen Engineering sought an injunction against Barclays Bank in order to restrain payment of the bond.

Lord Denning concluded that the bank must pay on first demand and without proof default or conditions. The bond could, therefore, be called upon even if the breaches were non-existent. Lord Denning expressed the view that an on-demand bond was rather akin to discount as it could be called upon at any time and seemingly without reason by the beneficiary. An on-demand bond is, therefore, akin to cash and perhaps should be built into the contractor's price.

It is for this reason that contractors strenuously resist the giving of on-demand bonds. A contractor would be relying upon the goodwill of the beneficiary rather than a legal right to restrain payment. However, in the case of *Edward Owen* Lord Denning made it clear that the bond must be honoured except in the case of clear fraud. However, most cases demonstrate that the threshold for proving fraud is high.

There are a variety of situations in which it may be possible for a contractor to obtain relief against a call on the bond. In some instances it may be possible to obtain an injunction against the bank restraining payment of the bond or in other circumstances it may be possible to obtain some recourse against the beneficiary.

The fraud exception

In the case of *Edward Owen* the claimant sought to argue that the Libyan buyers had failed to reply to any requests for a suggestion of any default or breach. As a result the claimants argued that the Libyan buyer's claim was clearly fraudulent. However, Lane LJ disagreed that this amounted to any proof or evidence of fraud. He said "it may be suspicious, it may indicate the possible of sharp practice, but there is nothing in those facts remotely approaching true evidence of fraud".[15] More recent cases have shown that it is far from easy for a judge to conclude that a demand is fraudulent in the absence of clear evidence.

When fraud can be proved, it must also be established that the bank had knowledge of the fraudulent claim. This in itself proves problematic. This is because:

1) A failure to produce any evidence is not sufficient (*Edward Owen*);
2) Knowledge of fraud will not be imputed into the bank;[16]
3) The bank is not under any obligation to investigate the dealings in respect of the principal contract.[17]

In the case of *RD Harbottle (Mercantile) Limited v National Westminster Bank Limited*[18] it seemed that the bank knew that the beneficiary of the bond had not established a condition precedent to the operation of a guarantee. Nonetheless the bank was obliged to pay the beneficiary. This was because the court considered that such issues were contractual disputes between the parties to the primary contract, and that any dispute in respect of them should be settled between the parties pursuant to the primary contract.

15 See above at 175
16 Discount Records Limited v Barclays Bank Limited [1975] 1 WLR 315
17 See footnote above
18 [1978] 1 QB 146

The bond on its true construction is conditional

The terms "on-demand bond" or indeed "bond" is not decisive. A document described as a "bond" was held to be a guarantee which was conditional in the case of *Trafalgar House Construction (Regions) Limited v General Surety & Guarantee Co Limited*.[19] It is therefore important to carefully review the terms of a bond in order to ascertain whether it is on its true construction an on-demand unconditional bond, or whether in fact it is a performance guarantee.

The terms required for an on-demand bond are short and need to be concise and clear. Additional wording might not detract from the bond being unconditional providing that the operative "on first demand" provisions in the document amount to conclusive evidence that payment should be made. For example, in the case of *Esal (Commodities) Limited v Oriental Credit Limited* the bank undertook:

> "… to pay the said amount on the written demand in the event that the supplier failed to execute the written performance"

It was held that the bond was an on-demand bond and payable upon a written demand. The beneficiary did not need to demonstrate that the supplier had failed to perform. Further, Staughton LJ in the case of *IE Contractors Limited v Lloyd's Banks plc*[20] said that there was a presumption that performance bonds were payable upon the presentation of the appropriate documents, which in the case of an unconditional bond simply meant the making of a written demand.

The inclusion of a "conclusive evidence clause" might also have the effect of making it clear that the bond is an on-demand bond regardless of any other term. In the case of *Balfour Beatty Civil Engineering v Technical & General Guarantee Co Limited*[21] Waller LJ said, in the Court of Appeal, that the bond contained language which "seems to me to make it absolutely clear that this is a bond intended to be met without the surety having either the right or the duty to make any detailed enquiry provided the demand letters conforms with the conditions of the bond."

Deficient demands

Another challenge that is sometimes successful is where the written demand placing a call upon the bond is itself deficient. This can arise in a variety of ways.

In the case of *GKN Contractors v Lloyds Bank Plc*[22] the demand was made by a successor in title rather than the beneficiary named in the bond. The substantive applicable law of the bond was Iraqi law and it was arguable that the demand was therefore not valid.

In *Franz Maas (UK) Limited v Habib Bank AG Zurich*[23] a call could be made on the bond in writing where the principal "had failed to pay… under [its] contractual obligations". The demand stated that there had been a failure "to meet contractual obligations".

The Court held that a demand to meet contractual obligations was not the same as a demand based on a failure to pay. This was because the failure to meet contractual obligations could be a claim for damages including unliquidated damages which was wider than the scope of the guarantee that related to certain liquidated sums.

19 See above
20 [1990] 51 BLR 1
21 (1999) 68 Con LR 180
22 (1985) 30 BLR 48
23 [2001] Lloyd's Rep 14

However, it is not always crucial to repeat the precise words set out in the bond. For example, in the case of *IE Contractors Limited v Lloyd's Bank Plc* the Court of Appeal held that the written demand must state in substance that the claim was in respect of damages for breach of contract. The demand was a demand for a breach of contract. It did not specifically refer to a claim for damages. However, the Court of Appeal held that the call was sufficient in "substance" to be a valid demand.

It is worth remembering that even if a party obtains an injunction restraining a call on the bond because of a deficiency in a demand this usually only means the beneficiary will then issue a valid demand. The practical effect of obtaining an injunction is merely one of a delaying tactic unless of course the bond expires in the meantime.

Qualifications in the primary contract

Some limited authority exists in Australia that a contractor might be able to obtain injunctive relief where the primary building contract contains a qualification on the right for the beneficiary to call upon the bond.[24] The injunctive relief was against the beneficiary who was restrained from making a call on the bond.

This is a departure from the normal route of obtaining an injunction against the bank, which in these circumstances would have been obliged to pay because of the unconditional nature of the bond. That is why the only effective remedy would be an injunction against the beneficiary.

Duty to account

In *Trafalgar House v General Surety* the question of an overpayment by the bondsman arose. In such circumstances would the beneficiary be able to keep the full amount of the bond? Without hesitation the House of Lords accepted that the Beneficiary would have to repay any excess, but this was in respect of a performance bond.

What is the position if the bond is an on-demand bond? Based upon the case law that simply states that an on-bond is to be paid it seems unlikely that a principal would have much opportunity in practice to reclaim the sum. Even if one takes the view that the excess should be repaid because the written demand was based upon a claim that turned out to be untrue, the practical problem will be demonstrating that there has been an overpayment.

Further, should any overpayment be repaid to the bank because the beneficiary received the money from the bank pursuant to the undermined bond, or alternatively is the amount to be repaid to the principal? In most circumstances it may not matter because the amount will ultimately be received by the principal. However, it will matter in the case of insolvency of the principal. Especially, if the insolvency has been brought about because the bondsman has exercised a cross guarantee because of the call upon the bond.

Under a performance guarantee the bondsman is in contract with the beneficiary. Arguably the ordinary restitutionary remedies apply, and the amount should be repaid to the bondsman. However, an on-demand bond is a banking instrument and the bank

24 Woodhall Limited v Pipeline Authority (1979) 141 CLR 443

will have no right against the beneficiary of the bond. This is based on the argument that there cannot be a wrongful call upon a letter of credit, and on-demand bonds are much the same as letters of credit. The principal should therefore be able to sue the beneficiary direct.

Direct authority for a duty to account can be found in the case of *Cargill International SA v BSFIC.*[25] That case concerned a bond given in respect of a primary contract of sale. In the Court of Appeal it was said that:

> "It is implicit in the nature of a performance bond that in the absence of clear contractual words to a different effect there will be an accounting between the parties at some stage after the bond had been called, in the sense that their rights and obligation will be determined at some future date. If the amount of the bond is not sufficient to satisfy the beneficiary's claim for damages he can bring proceedings for his loss, given credit for the amount received under the bond. Conversely, if the amount received under the bond exceeds the true loss sustained, the party who provides the bond is entitled to recover the over payment".[26]

There is, therefore, an implied obligation of repayment based upon restitutionary principals. However the Court of Appeal considered that this was only in the absence of "clear contractual words" to the contrary. So, it seems that it is possible to exclude the duty to account by clear contractual wording. The Court of Appeal did not consider this proposition further. However, Morrison J at first instance in *Cargill* considered that if the terms of the contract provided for the beneficiary to retain monies even if they had not suffered any damage then he would have held the contractual provision to be penal.[27]

Conditional bonds

Conditional bonds are construed as guarantees, and are therefore subject to the law of suretyship. Liability is co-existent with liability under the primary underlying contract. The conditional bond is security against the contractor's obligations under the building contract. One would expect it to remain in force until at least practical completion pursuant to the building contract. The ABI Model Form of Guarantee Bond provides an example of the typical operative provisions of a conditional bond:

> "The Guarantor guarantees to the Employer that in the event of a breach of the Contract by the Contractor the Guarantor shall subject to the provisions of this Guarantee Bond satisfy and discharge the damages sustained by the Employer as established and ascertained pursuant to and in accordance with the provisions of or by reference to the Contract and taking into account all sums due or to become due to the Contractor".[28]

It is conditional in the sense that the damages must be "established and ascertained" in accordance with the primary contract. As the law of suretyship applies, the bond issuer is in the same position as the contactor. Further, The bondsman can be discharged by release of the contractor from further obligation and also by variation of the construction contract.

25 [1998] 2 All ER 406
26 As above, at 410.
27 [1996] 4 All ER 563, at 573,
28 ABI Model Form of Guarantee Bond, available from the Association of British Insurers website
29 (1994) 66 BLR 72

The requirement of breach

The obligations under the guarantee only arise if there is a breach of the primary contract. Insolvency might lead to breach of contract unless the contract contemplates insolvency
and provides for it. In the case of *Perar BV v General Surety & Guarantee Co Limited*[29] the primary building contract terminated because the contactor went into administrative receivership. The building contract was the JCT Standard Form of Building Contractor with Contractor's Design (1981) Edition. Clause 27.2 of the contract stated:

> "In the event of the Contractor… having an administrative receiver, as defined in the Insolvency Act 1986, appointed… the employment of the Contractor under this Contract shall be forthwith automatically determined…"

The administrative receiver did not intend to reinstate the contractor's employment. The employer therefore made a call on the bond. The Court of Appeal decided that the Employer could not treat the automatic determination of the employment of the contractor as an abandonment of the work amounting to a repudiation of the contract because the contract specifically provided for the event of insolvency. The administrative receivership of the contractor was therefore not a breach of contract.

The case of *Tower Housing Association Limited v Technical & General Co Limited*[30] concerned a design and build contract based upon the JCT Form. The operative part of the Bond provided that the employer was entitled to call on the bond:

> "in the event of a proven breach of the Contract… or in the event of determination of the Contractor's employment under the Contract for reasons of insolvency whether such determination is automatic or otherwise, …"

The contractor went into administrative receivership and the employer determined the contractor's employment. The surety refused to pay and so the employer commenced proceedings.

The surety did not dispute that it would be obliged to pay any shortfall to the employer. However, the surety argued that it was not obliged to pay the costs of completion until after completion by the alternative contractor, in accordance with the determination provisions of the contract.

HHJ LLoyd QC refused to grant immediate payment. While then it appears that specific references to the determination provisions of the contract and references to insolvency within the terms of a performance bond allow employers to call upon the bond in the event of insolvency these provisions do not assist the employer to obtain the immediate cash flow that they require in order to complete the project.

In *Perar*, the Court of Appeal considered that the contract included an exclusive code setting out what was to happen in the event of insolvency. This exclusive code of determination thus precluded termination for repudiation. However, it may be possible to avoid this problem by the inclusion of the words "without prejudice to many other legal or equitable right or remedy which the owner or employer would otherwise possess hereunder as a matter of law".

30 (1998) 87 BLR 74
31 (1997) 55 CON LR 1

This additional provision was included in the bond in the case of *Laing Management Limited v Aegon Insurance Co (UK) Limited*.[31] The bond had been provided by a sub-contractor to a main contractor. The sub-contractor was put into receivership. That did not constitute repudiation. However, when a statement of claim was issued this amounted to an act of repudiation thus generating a damages claim against the contractor, and therefore against the bondsman. These additional words are not fool proof, and a direct reference to the clause in the primary contract dealing with insolvency is preferred.

To overcome this difficulty bonds are regularly amended in order to make specific reference clause 27 of the JCT Contract. An example of such and amendment arose in the case of *Paddington Churches Housing Association v Technical & General Guarantee Co Limited.*[32] The operative provisions of that bond stated:

> "NOW THE CONDITION of the above-written Bond is such that if the Contractor shall duly perform and observe all the terms provisions conditions and stipulations of the said Contract on the Contractor's part to be performed and observed according to the true purport intent and meaning thereof or if on default by the Contractor or <u>for the avoidance of doubt a valid determination of the Contractor's employment under clause 27 of the said Contract</u> the Surety shall satisfy and discharge the net established and ascertained damages sustained by the Employer thereby up to the amount of the above written Bond then this obligation shall be null and void but otherwise shall be and remain in full force and effect up to the date of issue of the Statement of Practical Completion the Surety shall satisfy and discharge the net established ascertained damages sustained by the employer thereby up to the amount of the above written bond then this obligation shall be null and void but otherwise shall be and remain in full force and otherwise shall be and remain in full force and effect up the date of the issue of the Statement of Practical Completion…" [emphasis added]

The Courts held that a call could be made on the bond because of the specific reference to clause 27. However, the bondsman incurred no liability until a statement of the "net established and ascertained damages" had been provided in accordance with the calculation process set out in clause 27.

Conditions precedent

A bond may be subject to conditions precedent. For example, in the case of *Oval (717) Limited v Aegon Insurance Co (UK) Limited*[33] the beneficiary was required by a clause in the bond to inform the bondsmen in writing of any:

> "non-performance or non-observance on the part of the contractors of any of the stipulations or provisions contained [in the main contract] and on their part to be performed and observed within one month after such non-performance or non-observance shall have come to the notice of the employer".

The employer failed to provide such written notice of the contactor's failure to complete the construction within the one month period. The employer was held unable to make a

32 [1999] BLR 244
33 (1997) 85 BLR 97
34 Unreported 10 May 1999

call on the bond because of failure to comply with the condition precedent. The burden placed upon the employer to notify the bondsmen of such non-performance is a high one where such a condition precedent is included within the bond. This should be contrast with the case of *Odebrecht Oil & Gas Services Limited v North Sea Production Co Limited*[34]. In that case the notification clause in the bond stated:

> "If the Employer reasonably believes that there has been a breach of the Contract by the Contractor, he shall give written notice thereof to the Contractor and to the Guarantor, specifying the nature of such breach and his estimate of the amount of the Damages arising therefrom". [emphasis added]

The Court decided that the beneficiary did not need to set out in the notice the precise acts or omissions which were alleged to have constituted the breaches, nor did the notice need to include the date of any of the breaches. This was because the notification clause only required the employer to give notice of the "nature" of the breach not particulars of the breach.

Duration of the bond

Bonds are usually expressed to expire on the date of practical completion or the issue of the date of the statement of practical completion pursuant to the underlying construction contract. Depending upon the terms of the bond, this most usually means that the call must be made on the bond before practical completion. A call made on a bond after the expiry of the bond will be ineffective. In this respect, the inclusion of an expiry date operates in a similar manner to that of a condition precedent.

In the case of *Lorne Stewart Plc v Hermes Credit Kreditversicherungs*[35] it was held that the bondsman had no liability to the beneficiary where a demand for payment was posted to the bondsman after the termination date of the bond.

Variation and indulgence clauses

The bank or bondsman agreed in a conditional bond to guarantee the underlying contractual obligations. If there is a material variation to the underlying contract then the surety is discharged. This rule was established in the case of *Holme v Brunskill*[36]

This is unless the bond contains a provision that allows for variation. This is of course extremely important in construction contracts because the works are frequently varied and arguably the nature of the underlying contract is often subject to a material variation. It is for this reason that most bonds include an "indulgence clause" which recognises that the underlying contract will be varied, and confirms that the bondsman will still meet a call on the bond.

The ABI model form of guarantee bond

The Department of the Environment commissioned a firm of solicitors, as a result of the Latham Report, to produce a report that ultimately led to the formulation of a model form of bond. The bond has ultimately been made available by the Association of British Insurers, and can be downloaded from their website. In the latest version published in September 1995, care is needed in its use. For example, it does not provide for a call

35 Unreported 22 October 2001
36 (1878) 3 QBD 495

to be made on the bond in the event of insolvency, which is covered by a contractual provision in the primary contract. It will therefore need to be amended if it is to be used.

Current problems with bonds

The Surety's obligation in respect of Arbitration Awards

According to Richard Wilmott-Smith QC this problem only really occurs when a contractor has not defended an action and the employer obtains judgment which a proper defence might have avoided. This is of course more likely to occur where the contractor is in financial difficulties and perhaps becomes insolvent. The employer will then look to the bondsman. Can the bondsman plead substantive issues in respect of the breach when court proceedings are brought against the bondsman?

There are a number of cases dealing with this issue. The older cases indicate that legal cost cannot be claimed from the bondsman. For example, *Hoole District Council v Fidelity & Deposit Company of Maryland*[37] found that the legal costs could not be added to the amount of damages that were awarded pursuant to the arbitration agreement. In that case the bondsman had admitted liability for the damages, but denied liability as to costs. In more recent cases, in particular *Agromet Motoimport v Maulden Engineering*[38] Otton J came to the conclusion that an action to enforce an arbitrator's award is an independent cause of action. An arbitrator has the power to deal with costs as part of an award. It therefore seems that the liability of a bondsman will include the costs ordered to be paid in respect of enforcement of that cause of action.

Surety's obligation in respect of Adjudicator's Decision

The Housing Grants, Construction & Regeneration Act 1996 requires construction contract as defined to include adjudication. In the absence of provisions dealing with adjudication Section 108 of the Housing Grants, Construction & Regeneration 1996 will imply the Scheme which sets out the procedure adjudication into the construction contract.

This raises a variety of questions. For example, will a bondsman be obliged to pay pursuant to the decision of an adjudicator in respect of the ascertainment of damages, or will the bondsman be able to resist until the amount had been ascertained pursuant to "legal proceedings" such as arbitration or litigation?

Further, is a bond caught by the 1996 Act. In other words is it a construction contract as defined in sections 104 and 105 of the Act. Essentially, for a bond to amount to a construction contract it would need to arrange for building operation.

Most usually a performance bond does not arrange for building operations, but instead provides a guarantee in the event of a breach of the underlying contract. It therefore seems unlikely that adjudication would be implied into a performance bond. However, there is no reason why contractual adjudication provisions could not be incorporate within in a bond in order to ascertain the liability of bondsman. Bondsmen are extremely reluctant to include such provisions, and it is likely that adjudication under the primary contract will be sufficient to demonstrate a liability of the bondsman.

37 [1916] 1 KB 24
38 [1985] 1 WLR 762

Problems in respect of Management Contracts

The interesting aspect about management contracts is that they usually provide that the contractor is liable to the employer, but only to the extent that the contractor is able to recover damages from a works sub-contractor. In practice this means that the management contractor's exposure to the employer is extremely limited.

Given that the usual wording of the performance bond requires the beneficiary to establish the damages it would seem that an employer calling upon a bond given by a management contractor would be required to establish the actual loss and/or damage suffered as a result of a breach by the management contractor. It usually transpires that there is minimal exposure for the management contractor, and so arguably the bond is of little value to the employer.

Bonds in practice

Where a bond is used, it is usually requested for 10% of the contract sum. In some instances this may be increased, and it is not unusual to see a bond for 20% of the contract sum. In respect of international contracts a 100% bond may be required, although these are difficult to obtain.

In respect of the usually encountered 10% bond in the UK the cost is relatively low. The cost will depend upon the experience and substance of the contractor and also the length of the contract and the size of retention. Ultimately, it depends upon the nature and substance of the contractor. On the other hand, on-demand bonds are expensive and difficult to obtain.

An important feature from an underwriting perspective is the counter indemnity. This is obtained from the contractor to the surety bondsman. Where a bondsman obtains a counter indemnity from the contractor this should always be obtained from the ultimate parent of the contractor if it is to have any useful worth.

The purpose of a counter indemnity is for the bondsman to obtain reimbursement of any advances paid out under the bond.

Hybrid bonds

A distinction has been made between unconditional bonds and conditional performance bonds. However, some hybrid forms have appeared.

Rather than placing payment on a first written demand by the employer or requiring proof of loss pursuant to the underlying contract these hybrid bonds are based upon the documentary evidence of some third party. For example, the bondsman might make a payment pursuant to the ascertainment and certification by an architect or some other construction professional. The bondsman and contractor have the comfort of knowing a third party professional would have reviewed the alleged damages and arrived at a calculation for those damages.

On the other hand, the amount may not be correct as it will not be subject to a detailed investigation that might be required by the underlying contract. Nonetheless, these

documentary bonds provide immediate cash flow which is arguably the purpose of the beneficiary taking out a bond. If a contractor fails to complete the building, then it is immediate cash that the employer requires in order to complete as a result of the contractor's default. Waiting for many months or indeed years while the loss is ascertained pursuant to the underlying building contract does not assist the employer in completing the work.

Variations of the traditional performance bond

A variety of variations to the traditional or modern default bond, which are typically used for the duration of the construction phase, include:

1) *Bid or tender bonds*. The purpose of these is to reimburse the employer for the loss or damage that might occur if a contractor does not complete the tender process. These are more commonly encountered in the USA and Canada. The bond can usually be called upon if the tender is withdrawn, if the tender does not execute the building contract if successful, or if a performance bond is not then provided. Bid bonds are usually on-demand and can be called by the employer at any time. This is to deter the tenderers from wasting the employer's tendering efforts.

2) *Retention bonds or guarantees*. Once again these are usually on-demand bonds and so are primary undertakings to make a payment. This is because they are given instead of retention (i.e. in lieu of cash), and therefore the employer should be able to obtain the cash immediately. They improve a contractor's cash flow, but at the same time provide the security for the amount of retention.

3) *Advanced Payment bond*. If a contractor is to obtain an advanced payment under the contract, but before carrying out any material works, then an employer might require an advanced payment bond. If the contractor does not then fulfil its obligation the employer is able to call upon the bond in order to obtain recompense. Once again these are usually on an on-demand primary contractual obligation basis.

4) *Maintenance bond*. These are similar to retention bonds. They are used to cover a contractor's obligation during a maintenance period and are therefore much the same as the employer holding retention money during the maintenance period.

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