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Performance bonds and bank guarantees

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Introduction

There is a range of options available to protect Owners against the non-performance of a Contractor including:

- retention
- liquidated damages
- indemnity and set-off provisions
- parent company or shareholder guarantees
- performance bonds
- bank guarantees.

This update focuses on the use of performance bonds and bank guarantees.

What are performance bonds and bank guarantees?

Performance bonds and bank guarantees may be either conditional or unconditional. They are normally issued by banks or insurance companies.

What is the difference between conditional and unconditional performance bonds or bank guarantees?

A conditional bond or bank guarantee may only be called on actual proof of default and damage, such as an arbitration award or court judgment, and the payment will only cover the proven loss sustained by the Owner/Beneficiary up to the amount stated in the bond or bank guarantee.

An unconditional/demand bond or bank guarantee does not require any proof of default, and the Owner/Beneficiary will generally receive payment of the full amount upon the presentation of a written statement to the issuer stating that the Contractor has failed to perform. In the absence of fraud and, in certain jurisdictions (Singapore and some Australian states) unconscionable conduct, the issuer must pay upon the receipt of a demand provided the demand notice, and any other documents required by the bond or bank guarantee, are in order.

How do you distinguish conditional bonds or guarantees from unconditional bonds or guarantees in practice?

The distinction between conditional and unconditional bonds and bank guarantees is not always clear due to ambiguous drafting or the creation of hybrid bonds or bank guarantees.

Generally conditional bonds and bank guarantees can be identified by:

- wording which makes payment under the bond or bank guarantee conditional upon the proof of breach of the underlying contract (as opposed to mere notice of a breach) by the Contractor
- the existence of notice provisions as to the existence of a default or of the intention to claim, as conditions precedent to any call on the bond or bank guarantee

- the bond or bank guarantee being signed by the Contractor. Unlike the unconditional bond or bank guarantee, the conditional bond or bank guarantee depends on the obligations owed by the Contractor to the Owner under the contract, and the Contractor must be a party to it

- the absence of words typically found in unconditional bonds or bank guarantees such as "…on receipt of its first demand in writing…the bank/surety will fulfil its obligations under the bond or bank guarantee without any proof or conditions…".

What are hybrid bonds and bank guarantees?

Hybrid bonds and bank guarantees arise where payment of a demand under what is essentially an unconditional bond or bank guarantee is made subject to conditions such as:

- the production of an architect/surveyor/engineer's certificate stating its opinion that there is a breach of the contract and the amount stated in the demand is the appropriate compensation for the breach

- authentication of the signature of the Owner in the demand

- authentication of the signature of the architect/surveyor/engineer in the certificate.

Such conditions should be rejected by an Owner seeking an unconditional bond or bank guarantee. Issuers are unlikely to seek clarification of hybrids or vague wording during negotiation, because where a dispute arises, an unclear bond or bank guarantee is likely to be found to be conditional, which is in their own and their customers' favour.

Further conditions to an unconditional performance bond or bank guarantee arise where the contract provides conditions to the payment of the demand (for example, that the Contractor is in breach and has failed to remedy the breach within X days after receiving notice from the Owner requiring him to do so). This type of clause creates obligations between the Owner and Contractor separate from the obligations between the Owner and the issuer of the bond or bank guarantee. This could lead to the Owner being in breach of contract by calling on the apparently unconditional bond or bank guarantee. To avoid this problem, it is in the Owner's interests that the contract does not mention the performance bond or bank guarantee or any related conditions.

Bond or bank guarantee duration

Where a conditional bond or bank guarantee contains no express provision fixing the time of release, the bond or bank guarantee is usually released upon:

- the surety satisfying damages sustained by the Owner in the event of a default of the Contractor

- the determination of the contract due to the insolvency of the Contractor (subject to the maximum liability stated in the bond or bank guarantee)

- the performance of all the Contractor's obligations under the contract.

Without an express time limit, it may be argued that the sureties' liability continues until every single obligation of the Contractor under the contract is performed, or even continues indefinitely. In our experience, it is rare for bonds or bank guarantees not to include an expiry date.

Calling on an unconditional bond or bank guarantee

An Owner calling on an unconditional bond or bank guarantee simply gives a written demand to the issuer stating the Contractor's failure to perform. In the case of a hybrid bond or bank guarantee, it must ensure it

complies with any other requirements or formalities. The English and Hong Kong courts and arbitrators applying the laws of those jurisdictions will generally only intervene if there is clear evidence of fraud.[1]

In Singapore, and some jurisdictions in Australia, unconscionability has been established as a further ground upon which the courts or arbitrators will impose an injunction to prevent a call.

In Australia, the suggestion that unconscionable conduct could be a ground for a court to intervene in the call of a bond arose in obiter comments [2]It was established as a ground to grant an injunction to prevent a call of a demand bond in the context of Section 51AA of the Trade Practices Act, which provides that 'a corporation must not, in trade or commerce, engage in conduct that is unconscionable within the meaning of the unwritten law, from time to time, of the States or Territories.'[3]

Arguably this Australian decision could be extended to find that it is unconscionable to call a performance bond when the work it secures has been substantially and properly performed and is a significant inroad into the autonomy of performance bonds, although this was not the intention of the legislature when drafting the Trade Practices Act.[4]

In contrast, the Singapore Court of Appeal made a clear and conscious decision that fraud or unconscionability are the sole criteria for deciding whether an injunction should be granted or refused. However, a high degree of strictness applies and mere allegations of fraud or unconscionability are insufficient to prevent a call.[5] This clearly erodes the primacy of the principle of autonomy strictly adhered to by the English and Hong Kong courts in the absence of fraud.

In England the court will not normally grant an injunction restraining the enforcement of an unconditional bond unless there is fraud. However, the court will not entirely ignore the underlying contract.[6] If the Contractor has lawfully avoided the underlying contract, or there is a failure of its consideration, the court might prevent a call on the bond.[7]

Calling on a conditional bond or bank guarantee

With a conditional bond or bank guarantee, enforcement is unlikely to be achieved quickly unless:

- the default of the Contractor is so obvious that it plainly cannot be disputed
- no defence or set-off is available to the Contractor/surety in answer to the call.

The difficulty with conditional bonds and bank guarantees is the need for proof of:

- actual default and damage suffered. A mere assertion of default and damage will not suffice[8]
- the actual amount of damages suffered.

Accordingly, it is not recommended legal proceedings be commenced to recover bond or bank guarantee money unless it is clear that the default and damage is undisputable.

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1 *Bollore Furniture Ltd v Banque National de Paris* [1983] HKLR 78; *Bolivinter Oil SA v Chase Manhattan Bank* [1984] 1 All ER 351.

2 *Hortico (Australia) Pty Ltd v Energy Equipment Co (Australia) Pty Ltd* (1985) 1 NSWLR 545 (Young J); *Hughes Bros Pty Ltd v Telede Pty Ltd* [1991] 7 BCL 210 (Cole J).

3 *Olex Focas Pty Ltd v Skodaexport Co Ltd* [1998] 3 VR 380.

4 Ben Zillman, 'A Further Erosion Into the Autonomy of Bank Guarantees?' (1997) 13 *Building and Construction Law* 354.

5 *Bocotra Construction Pte Ltd v Attorney General (No 2)* [1995] 2 SLR 733.

6 *Themehelp Ltd v West* [1996] QB 84; *Balfour Beatty Civil Engineering v Technical & General Guarantee Co Ltd* (1999) 68 Con LR 180.

7 *Potton Homes Ltd v Coleman Contractors (Overseas) Ltd* (1984) 28 BLR 19.

8 *Tins Industrial Co Ltd v Kono Insurance Ltd* (1987) 42 BLR 110.

The position under English law is that the Owner's right to call on the bond or bank guarantee depends on the court's construction of the bond or bank guarantee.

If the bond or bank guarantee guarantees the Contractor's performance, the Owner has to establish damages occasioned by the breach of conditions (and if the Owner succeeds, they recover the amount of damages proved).[9]

If the bond or bank guarantee is conditional on facts other than the Contractor's performance, the Owner can establish the relevant facts, and does not need to prove a breach.[10]

The court presumes that bonds or bank guarantees are to be conditioned upon the presentation of documents, rather than the existence of facts, unless it is obvious that the existence of facts is required.

Considerations during negotiation of a bond or bank guarantee

Generally:

- Owners should require an unconditional bond or bank guarantee, with a right to assign and charge the benefit of the bond or bank guarantee on the beneficiary. For the reasons mentioned above, no conditions regarding the calling of the bond or bank guarantee should be included in the contract.
- Contractors should try to insert conditions in respect of the bond or bank guarantee in the contract.
- A governing law should be inserted in the bond or bank guarantee.
- The bond or bank guarantee should be executed as a deed to avoid problems with consideration.
- Consideration should be given to the desired effect of the performance bond or bank guarantee and any alternatives (such as liquidated damages). The level of comfort sought should be balanced against any potential impact on the contract price.
- The notice requirements, for example, form of notice and address for service of notices.

With conditional bonds or bank guarantees:

- Consider rejecting provisions requiring the Owner to give notice to the issuer of the Contractor's default and the Owner's intention to claim, creating a condition precedent which can invalidate the Owner's call if the required notice is not given.
- Consider rejecting provisions giving the issuer the right to carry out the works itself.
- Ensure that the insolvency of the Contractor is referred to expressly as a default allowing the Owner to call the bond or bank guarantee.
- Ensure that it is expressly provided that the bond or bank guarantee is not to be rendered void due to any alteration of the contract between the Owner and the Contractor.

With a hybrid bond or bank guarantee, consider rejecting provisions obliging the Owner to exhaust all prior remedies before resorting to calling on the bond or bank guarantee.

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9 *Nene Housing Society v The National Westminster Bank* (1980) 16 BLR 22; *Tins Industrial Co v Kono Insurance* (1987) 42 BLR 110.

10 *Esal Commodities & Reltor v Oriental Credit* [1985] 2 Lloyd's Rep 546; *Siporex Trade v Banque Indosuez* [1986] 2 Lloyd's Rep 146.

Conclusion

Careful consideration should be given to the type of bond or bank guarantee suitable for a particular party during contract negotiation.

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