General

18 Key issues for performance bonds

Investing in Energy Transition Projects

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Introduction

An unconditional undertaking, sometimes referred to as a bond, is a promise given by a financial institution, usually a bank or an insurance company (**Promisor**), to pay an identified beneficiary (**Beneficiary**) on demand by the Beneficiary. In the context of construction contracts the Beneficiary is usually the Principal.

The bond is:

- unconditional
- valid up to a nominated amount
- usually valid for a specified time period
- usually not able to be assigned.

Unconditional undertakings are an essential part of most security packages in connection with major projects. They should be assessed in the context of the other elements of the security package, including retentions and third party guarantees; and other terms of the contract, including the payment system, set off provisions, liquidated damages and advance payment bonding.

The terms of the bond and the applicable contract (see below) will be the subject of detailed examination by financiers if it becomes necessary to call on the bond.

Contract structure

Bonds form part of a tripartite contract structure under which:

- the requirement to procure the bond is set out in the contract between the Principal (the Beneficiary) and the Contractor (**Underlying Contract**)
- the bond is a unilateral promise by the Promisor to the Beneficiary, effectively in the form of a deed poll
- the arrangements between the Contractor and the Promisor are set out, including the fees and the consequences of a demand on the bond.

Underlying Contract

The bond itself is unconditional (see below) and the Promisor must pay on demand notwithstanding the relevant context. However, it is the Underlying Contract that dictates the ability to make a demand on the bond and to disburse the proceeds of the bond.

The fundamental issues to be addressed in the Underlying Contract are whether:

- notice of the demand must be provided by the Beneficiary to the Contractor
- the Beneficiary must first establish a breach of the Underlying Contract as a condition for calling on the Bond.

The issue of notice is usually the subject of vigorous negotiation.

While the Beneficiary typically wants to avoid giving notice to limit the opportunities to injunct the demand, the Contractor is more likely to want notice so that it can either seek such an injunction or otherwise avoid the demand.

The second issue that goes to the heart of the purpose of the bond is the need for an established default. This is necessary to properly distinguish between the provision of the bond as a source of interim liquidity as the project proceeds and its provision as a security in the event that a default is ultimately established.

Both financiers and the Beneficiary will regard the bond as an interim liquidity measure to provide funds to complete the project, rather than as a conventional security.

This is usually the case given that establishing the default through dispute resolution may take years and incur substantial costs.

A balanced bond clause in the Underlying Contract will include the following elements:

- **The nature of the Promisor and its required credit rating:** The Promisor will usually be required to be a bank with an appropriate banking licence or a named financial institution with the required credit rating. The identity of the Promisor is usually subject to the reasonable approval of the Beneficiary.
- **When the bond must be provided and returned:** Bonds will be required to be provided to the Beneficiary either prior to, simultaneously with or shortly after the execution of the Underlying Contract. The bonds are typically returned in part on practical or mechanical completion and returned completely when all defects notified during the defects period have been rectified.
- **Grounds for calling on the bond that include a bona fide claim:** The grounds should include a bona fide claim by the Beneficiary for an amount payable under the Underlying Contract or for a breach of the Underlying Contract.
- **An express statement that the proceeds of a demand on the bond are NOT held on trust:** This is an important provision. The proceeds of the demand on the bond should be owned by the Beneficiary and not held on trust. If the funds are held on trust, then the Beneficiary will attract unwanted fiduciary obligations to the Contractor.
- **The period for which the bond must be valid and an obligation to replace the bond if completion has not been achieved by that time:** The period will be linked to the projected date for completion plus a margin to account for delays.
- **If agreed, a short notice period, but with the caveat that it does not diminish the bond's unconditionality:** The period, if agreed, should be no more than 48 hours.
- **The requirement to replace the Promisor should its rating fall below the required level.**
- **The consequences of the failure to provide or replace the bond:** This will usually be a termination event.
- **The consequences of a wrongful demand on the bond:** It should be stipulated that it is not a breach, but that there is a requirement to repay the funds with interest.

The difference between conditional and unconditional performance bonds

A conditional bond 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 Beneficiary up to the amount stated in the bond or bank guarantee.

Conditional bonds are rarely used in Commonwealth jurisdictions, particularly in projects with a high level of non-recourse financing.

Unconditional bonds must be paid on demand without any inquiry as to whether there has been a default.

Restraining payment or expenditure

Contractors will frequently seek to restrain the making of a demand on a bond, payment by the Promisor or the expenditure of the funds by seeking an injunction.

The injunction sought will be interim, in that the Contractor will seek to have the relevant conduct restrained until the issues can be heard in a full hearing. This might take a number of years to occur.

It is in this context that the terms of the Underlying Contract are crucial, as the terms of the bond itself will be completely unconditional.

If the terms of the Underlying Contract require that the default is first established, then the Court will restrain its use and the Beneficiary will be in breach of the Underlying Contract.

However, if the terms of the Underlying Contract only require that the Beneficiary has a bona fide claim before being entitled to act in relation to the bond, it will be far more difficult to restrain its actions.

Period of validity

Bonds will rarely be open ended. Therefore, the parties to the Underlying Contract will agree on the period of time that the bond is available. This is usually linked to the anticipated date of completion.

The Beneficiary can protect itself from the expiry of the bond by requiring that it be replaced prior to completion if it appears that completion will not be achieved by the projected date.

How to contact us

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