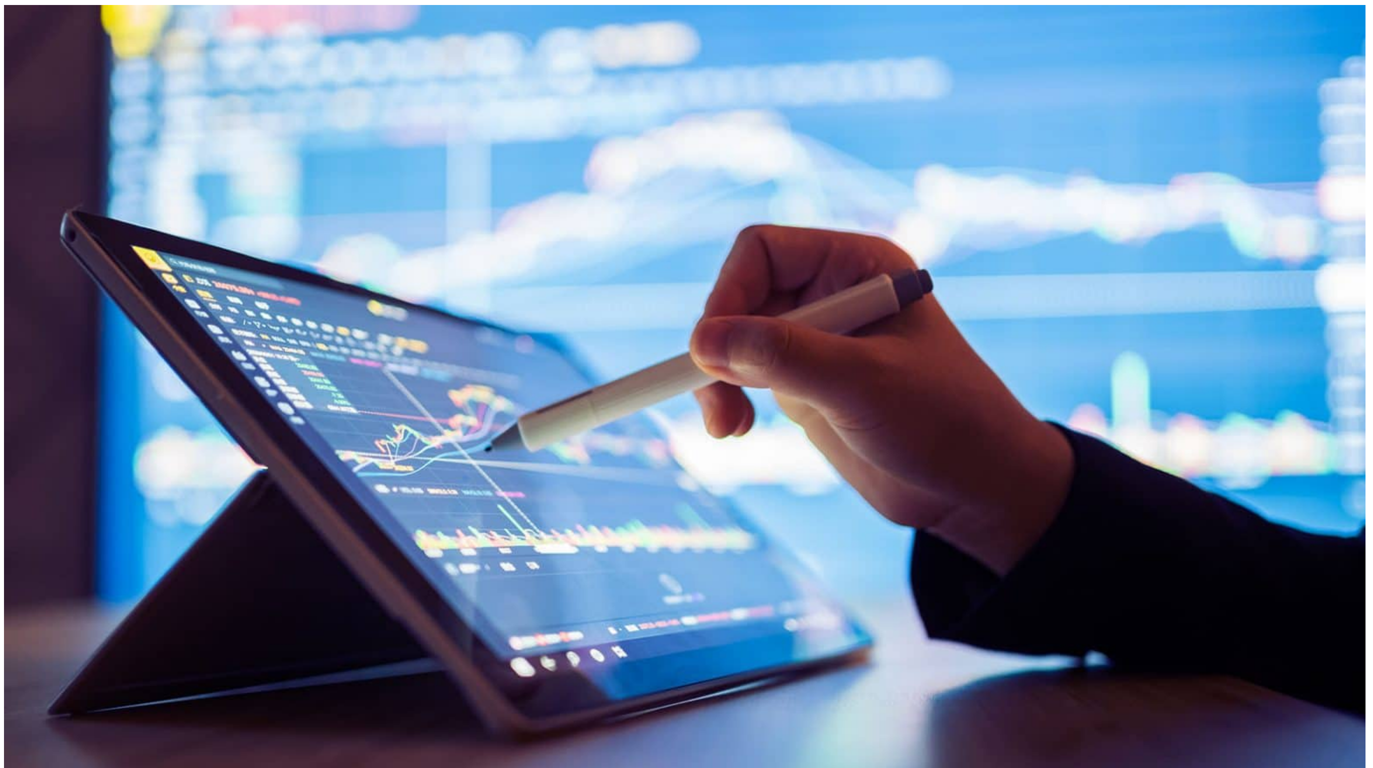
Cripps

Back to Basics: Performance Bonds



With the seemingly ever-present threat of contractor and supply chain insolvency, plus a tightening of the insurance market generally, we are receiving a number of enquiries over performance security and in particular the use of performance bonds. In this first of a "Back to Basics" series, we look at performance bonds and answer some commonly asked questions.

What is a performance bond?

A performance bond is a type of security document designed to ensure that the contractor complies with its obligations to carry out works in accordance with a construction or engineering contract. It allows the employer under that contract to claim back financial losses it may suffer as a result of the contractor's breach of contract up to a stated maximum sum (typically 10% of the contract sum) and for a limited period of time (typically either lasting until practical completion of the works or until the end of the defects rectification period).

It is important to realise that the contractor will probably look to charge the cost of the premium back to the employer, so the decision as to whether to obtain a bond usually involves a cost versus benefit analysis. The main reason for requiring one usually comes down to the perceived risk of contractor insolvency on a particular project, but there may be other factors to weigh up such as the works value and complexity.

What types of performance bond are there?

There are two basic types of performance bond, namely "on demand" bonds and "default" bonds.

An on demand bond provides the best security from an employer's perspective, but is rarely found in the UK

construction industry (they are more common in overseas projects). An on demand bond typically requires the bondsman to pay an employer's losses upon a simple written demand and does not require the employer to have proven a breach of contract by the contractor.

In contrast, a default performance bond requires the employer to establish the contractor's liability under the main contract first before a pay-out under the bond can be claimed. The exact method needed will depend on the wording of the particular bond, but this will usually involve either obtaining an award from an adjudicator, court or arbitrator in the employer's favour (depending on the applicable method of dispute resolution under the main contract). It is also worth remembering at this point that the bondsman's liability is co-extensive with the contractor's liability under the main contract so that the bondsman can rely on any counterclaims and defences available to the contractor under the main contract.

What is an "ABI bond"?

The most common form of performance bond we are seeing at the moment is the form published by the Association of British Insurers. This is a type of "default" bond. In order to claim under it, an employer will need to prove a breach of contract by the contractor as well as providing proof of the damages sustained by it as "established and ascertained" in accordance with the provisions of the main contract.

The standard ABI bond was considered in a Court of Appeal decision in *Perar –v- General Surety and Guarantee Co Ltd* in 1994, which cast some doubt over the ability of an employer to claim for contractor insolvency under the bond. The main problem was that the wording of the standard bond does not expressly refer to insolvency, rather to breaches of contract by the contractor, whereas insolvency is not automatically a breach of a building contract under most standard forms. It gives rise to a termination right by the employer, but it is not necessarily a breach of contract.

The ABI disputes that this is an issue, stating that, upon a contractor's insolvency, the contract will be terminated, the employer will take back possession of the site and engage a replacement contractor to complete it. In doing so, the employer is entitled to suspend all payments to the contractor and then any additional losses suffered by the employer as a result of the insolvency will become payable as a debt by the contractor. The failure then to pay that debt will be a breach of contract protected by the bond. Despite that explanation by the ABI though, many employers will seek to add in an amendment to the standard ABI bond to expressly state that insolvency is considered to be an event of default under the bond.

When will an employer be entitled to recover its losses under a bond?

Of course, the answer to this always depends on the wording of a particular bond and we recommend that proper legal advice is always sought before attempting to enforce one.

If an employer is lucky enough to have obtained an on demand bond, typically these can be claimed upon at any time. The employer will just need to make sure that it strictly complies with the claims procedure set out in the bond (including sending a written demand to the correct address for notice and providing all details required by the bondsman).

For default bonds, these usually require proof of the actual financial losses suffered by an employer as a result of the breach of contract. This can often only be done after the works have completed. For example, in an insolvency situation with a replacement contractor finishing the work, a calculation will need to be made between the initial projected cost of the project against the actual final cost in order to establish the additional losses suffered by the employer as a result of the insolvency situation. This is an important point for an employer to understand from a cash flow perspective as it may have to temporarily fund the additional costs itself until a claim on the bond can be made.

A way around this potential cash flow problem is to work in an interim mechanism whereby the written opinion of a quantity surveyor as to the projected additional costs may qualify as a method of temporarily quantifying a claim under a bond. This is then able to trigger an immediate pay-out, with a reconciliation exercise then taking place at the end of the project to establish the actual losses sustained. Whilst it is potentially a good solution for an employer, the drafting of these types of interim mechanisms can be complicated and unpopular with bondsmen, who may charge more of a premium to give those terms.

Summary

At the outset of every project, it is important for employers to consider whether a performance bond is necessary. It is often a cost versus benefit analysis, with the decision often coming down to the perceived risk of contractor insolvency on a particular project. If the employer considers a bond to be beneficial, the terms of that bond (value, duration and when a claim will pay out) all need to be carefully considered.

How we can help

If you need any help or advice on any topics related to performance bonds, please get in touch with our team and we will be happy to help.

James Lee

Partner