



Bonds, Warranties and Guarantees

Introduction

Bonds, warranties and guarantees - what you really need to know

1. Obviously a seminar on bonds, warranties and guarantees could be a fairly lengthy one and if pressed could probably take up the entire day. Fortunately, the title is limited to the bits we *really need to know*, thereby cutting out all those bits we don't need to know.
2. I thought the best approach would be to comment on the issues that crop up most frequently. I will highlight:
 - the basic legal principles underlying them (a refresher is always useful).
 - what some of the key provisions mean and why they are needed.
 - issues to consider when drafting and some of the common pitfalls.

Bonds and guarantees

The basic legal principles

3. I deal with these together on the basis that they are the two most common forms of security taken by employers on construction projects and, from a legal point of view, have much in common. However, there is a great deal of misunderstanding about the legal principles underlying them which is not helped by the numerous names which are applied to bonds and guarantees in the construction industry. These include: on-demand bonds, simple bonds, performance bonds, conditional-demand bonds, bank guarantees, demand guarantees, default bonds, performance guarantees, surety bonds, surety guarantees, parent company guarantees.
4. It is important to look beyond the names applied to these documents. The label attached to a document is not conclusive as to the legal principles upon which it is based.¹ Essentially the document should be based on one of two fundamentally different legal principles (but obviously the specific drafting means the position is often less clear than it could be and frequently results in a document falling somewhere in between these two principles).
 - (i) Primary obligation. This is simply an undertaking from the bondsman to pay a sum of money to the employer without reference to the liability of the contractor.² It is this principle which underlies a true "on-demand" bond. These bonds are common on international projects but less so in the UK (except in the case of advance payment and retention bonds). I will refer to these as on-demand bonds.
 - (ii) Secondary obligation (guarantee). This is where the bondsman's liability to pay the employer is contingent upon a breach by the contractor of the underlying construction contract. So if the employer cannot establish a breach by the contractor then the bondsman has no liability to pay. It is this principle that underlies the default bond, which is the more common form of bond used in UK projects. I will refer to this as a default bond but, as I have

1. This was illustrated in *Trafalgar House Construction (Regions) Ltd v General Surety v Guarantee Co. Ltd* [1995] 3 WLR 204; (1994) 66 BLR 42 where a document headed 'Bond' was first treated as a traditional bond, then treated as the equivalent of a demand bond in the Court of Appeal and then finally found to be a guarantee by the House of Lords.

2. The terms "employer", "contractor" and "bondsman" are used in this paper, rather than the legal titles generally applied of beneficiary/creditor, principal/debtor and guarantor/surety.

mentioned, they also have various other labels attached to them.

5. It is not always clear to distinguish whether a bond is truly on-demand or whether it is conditional upon breach of the construction contract. Clever (or not so clever) drafting also sometimes means that bonds fall somewhere in between. Some examples:
6. In a true on-demand bond you would usually expect to find wording along the following lines:

I promise to pay you £X on receipt of your written request without proof or conditions.

7. Wording to this effect is unusual in bonds used in UK construction projects and bonds tend to have conditions attached to them to limit a call. Unsurprisingly, these are known as conditional on-demand bonds. These conditions may include:

- a statement (usually from the architect/engineer) that the contractor is in default;
- enclosing copies of warning notices served on the contractor under the main contract;
- an adjudicator's award.

8. These provisions should not detract from the bond being an on-demand bond; it simply places hurdles in the way of a claim. There is no suggestion that any default on the part of the contractor needs to be demonstrated - the conditions are simply administrative. A true default bond would usually include wording such as:

The Guarantor guarantees to the Employer that in the event of a breach of the Contract by the Contractor the Guarantor shall discharge the damages sustained by the Employer as established and ascertained pursuant to and in accordance with the Building Contract.

9. The confusion that can arise where bonds sit somewhere in between true on-demand and default bonds has been considered most recently in the Australian case of *Clough Engineering Limited v Oil and Natural Gas Corporation Limited*.³ Clough was an engineering company engaged by ONGC in relation to the development of oil and gas fields off the coast of India. Various disputes arose which culminated in ONGC terminating the contract and making a call on the bond. The wording in the construction contract between Clough and ONGC provided that Clough was to provide an unconditional and irrevocable bond and ONGC would have the right to claim an amount up to 10% of the value of the contract "*in the event of the Contractor failing to honour any of the commitments entered into under this contract*".
10. The wording of the bond itself provided for the bank to pay immediately on first demand: "*on breach of contract by the Contractor without any demur, reservation, contest or protest or without reference to the Contractor.*"
11. Clough maintained that the wording in the contract prevented a demand being made and that ONGC had to prove breach on the part of Clough before a claim could be made on the bond. The Judge at first instance rejected this and held that it was sufficient for ONGC to call the bond where it had a bona fide belief that Clough was in breach. When both the contract and the bond were considered together it was clear that a claimed breach of contract was sufficient to trigger payment under the

3. [2008] FCA FC 136 (22 July 2008)

bond. This decision was upheld on appeal.

12. There are other key points which distinguish on-demand bonds from default bonds.

Formality

13. A guarantee, which is the legal basis of true default bonds, is similar to a simple contract in that all the requirements for a contract must be present, such as an intention to create legal relations, consideration, etc. In addition to this, a guarantee must be in writing to be enforceable.⁴ In the *Actionstrength* case⁵ a subcontractor sought payment directly from the employer where the main contractor had become insolvent. The subcontractor's claim was on the basis that the employer had said that the subcontractor should carry on working and that the employer would ensure that he got paid. The sub-contractor's claim failed on the basis that the apparent "guarantee" by the employer in respect of the main contractor's payment obligations had not been recorded in writing and so could not constitute a guarantee. This case is obviously a warning to contractors and subcontractors who proceed on the strength of a verbal assurance from a third party that they will be paid. The effect of the verbal assurance is probably intended to act as a guarantee but must satisfy the requirements of a guarantee before it can be relied upon.

Co-extensiveness

14. This principle provides, in practice, that the bondsman is only as liable as the contractor but this only applies to secondary obligations. Under an on-demand bond the extent of the bondsman's liability is dictated solely by the wording of the on-demand bond itself. Essentially, the bondsman is put in the same position as the contractor under a default bond.

Variation of the construction contract

15. One of the basic rules of a guarantee is that any variation in the construction contract could discharge the bondsman from liability.⁶ It is for this reason that the following will usually be present in any default bond:

The Guarantor shall not be discharged or released by any alteration of any of the terms, conditions and provisions of the Contract or in the extent or nature of the Works and no allowance of time by the Employer under or in respect of the Contract or the Works shall in any way release, reduce or affect the liability of the Guarantor under this Guarantee Bond

16. There is no need for such wording in on-demand bonds because they are a primary obligation operating independently of the underlying construction contract. However, just because a bond does not contain this wording is not conclusive that it must be an on-demand bond; it is necessary to look at the precise wording in each case.
17. A word of warning about relying on such wording. If the amendment to the construction contract is significant then it is still advisable to get the consent of the bondsman. For example, I have recently been involved in a project in which the contractor was initially engaged only in respect of the shell and core works. It was later agreed that the contractor would also fit-out the building and a variation was issued to that effect. To avoid any possibility that the guarantor (both under the parent company guarantee and the default bond) could avoid liability their express consent was obtained. Where variations are significant it is important to consider the impact they may have on any guarantee whether in the form of a

4. s.4 of the Statute of Frauds 1677

5. *Actionstrength Ltd (trading as Vital Resources) v International Glass Engineering In.Gl Spa and others* [2003] BLR 207

6. This rule was established in the case of *Holme v Brunskill* (1878) 3 QBD 495 in which it was said that "if there is any alteration to the terms of the guaranteed contract, the surety ought to be consulted and his consent sought. If the surety does not consent then the surety is discharged...except in cases where it is self-evident that the alteration is unsubstantial or must be beneficial to the surety". The rule in *Holme v Brunskill* was considered more recently in *Mercers Co v New Hampshire Insurance* [1992] 1 WLR, Lord Justice Scott, obiter of the rule "Mr Beloff invites us to adopt the approach of certain United States authorities and to hold that, where the surety is a professional compensated surety, the discharge of the surety brought about by a variation of the principal contract should be pro tanto an not absolute. I was impressed by the common sense approach of this transatlantic solution and by the undesirable rigidity of the rule in *Holme v Brunskill* in its application to compensated sureties. I was not convinced that binding authority stands in the way of the adoption of this sensible solution in this country, but it is not necessary for us to decide the point in the present case". This is clear support, albeit obiter, for a more common sense to the release of compensated sureties (by which it is meant those companies who provide bonds for a fee) rather than strict application of the rule in *Holme v Brunskill*.

default bond or a parent company guarantee.⁷

18. It is also important to consider how guarantees may be affected by more modern procurement routes such as framework agreements. The main advantage of frameworks is that contracts are “called off” as and when the employer wishes during the framework, with the intention that certain aspects of the project are agreed in advance - one of the most common being the terms and conditions. If setting up this type of arrangement it is important to consider how any guarantee is drafted. Firstly, frameworks in the private sector⁸ have a tendency to go beyond the scope of what was intended of the contractor at the outset. A contractor who has completed a number of successful projects for an employer can soon find himself undertaking more complicated and high value projects. If the guarantee obtained is in relation to all the obligations assumed under the framework, and these obligations materially change in scope and duration, the guarantor may be discharged. Secondly, you need to pay careful attention to the wording of the framework agreement. Often, they are written so that the contract between the parties for the actual work is a separate contract from the framework agreement itself. Any guarantee will need to take account of this.

Issues to consider when drafting and some of the common problems

The meaning of default

19. As I have mentioned, the most common form of bond issued on UK projects is the default bond as opposed to the on-demand bond. If there is no “default” then no call can be made on the bond (unlike the on-demand bond which is a primary obligation not dependent upon any default under the construction contract).
20. Default bonds are most commonly underwritten by insurance companies (with banks tending to underwrite on-demand bonds) and so, like any other insurer, they will look for a reason to avoid payment. That said, on many occasions the bond issuer will accept a call on the bond simply by demonstrating that the contractor is insolvent and then providing evidence of the actual costs of completion of the construction work. The key practical approach in these situations is to get the bondsman involved early. It is important to remember that the more the employer is able to demonstrate that the losses have been reasonably incurred (and properly mitigated) the less chance there is of the bondsman challenging those losses. For example, on a recent project I was involved in, as soon as the contractor became insolvent we involved the bondsman. The various options as to how to complete the works were discussed and “signed off” by the bondsman. These options included tendering the remaining works on a fixed price basis (but with the risk of overrunning and the employer becoming liable to a tenant for liquidated damages), or completing the works on a dayworks basis with far less risk of overrunning and incurring liquidated damages but obviously with less cost certainty. Because of the early involvement of the bondsman the losses were clearly demonstrated, mitigated and settled without delay on the part of the bondsman.
21. However, establishing “default” is not always so straightforward and things do not always go smoothly with the bondsman. Given that one of the main reasons an employer will want to call a bond is due to the contractor’s insolvency there have been a number of cases which have doubted whether insolvency is actually a default entitling a call to be made. In *Perar*⁹ the building contract terminated because the contractor went into administrative receivership. The contract was the JCT Standard

7. In *Marubeni Hong Kong and South China Ltd v The Mongolian Government* [2004] EWHC 472 (Comm) Mr Justice Creswell noted that “The question whether an alteration is insubstantial or cannot be prejudicial to the surety is answered objectively without reference to what the parties thought.”

8. Public sector frameworks are subject to EU law which restricts, amongst other things, the duration of the frameworks.

Form of Building Contract with Contractor's Design 1981 Edition. Clause 27.2 provided:

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

22. The employer made a call on the bond but the Court of Appeal held that the employer could not treat the automatic determination of the employment of the contractor as an abandonment of the contract amounting to repudiation. This was because the contract expressly set out what was to happen in such circumstances and set out what liability each party had to the other. It is for this reason that a well-drafted bond should always make clear that termination in these circumstances is a default for the purposes of the bond. For example:
23. "The Guarantor guarantees to the Employer that in the event of a breach of the Contract by the Contractor *or in the event that the Contract or the employment of the Contractor is determined by reason of one or more of the events set out in clause [insolvency clause] and notwithstanding any objection that may be raised* the Guarantor shall [satisfy the damages sustained].
24. A word of caution for those using the standard ABI bond. In its standard form it does not contain the wording underlined above and so it is doubtful whether it would respond to contractor insolvency. Employers being offered a standard ABI bond by contractors should try to get it amended.

Parent Company Guarantee v Default Bond

25. Given that default bonds are essentially based on the law of guarantee (and so many of the same issues arise) it is often queried why some project documentation still requires both forms of security and whether there are any advantages with one over the other.
26. Many contractors will argue that it is unreasonable for the client to request both a PCG and default bond. However, whilst legally they may have many similarities the practicalities of how and when they operate means that the employer's request for both can often be justified.
27. The PCG can be a very practical as well as legal remedy. If a subsidiary is not performing then in practice the employer will simply threaten to make a formal call on the PCG. In many cases this is sufficient to ensure that the parent company steps in and resolves the problems with its subsidiary's performance. The risk, of course, is that if the grounds for non-performance by the subsidiary are financial then there remains a high chance that the parent company may suffer the same fate. It is in these insolvency situations where the bond is likely to prove better security for the employer (subject, of course, to the financial standing of the bondsman).
28. The other major advantage to the PCG is that they tend to be drafted on the basis that the parent company's liability is identical in terms of duration as its subsidiary. By contrast most default bonds are drafted to expire at the end of any defects period meaning that latent defects appearing after this date are not caught.

Warranties

29. As I did with the talk on bonds and guarantees I will restrict this part of the talk to the bits we really need to know and some of the potential

problem areas. I have assumed, therefore, that all of us are familiar with the reasons why warranties are required.

30. There is very little case law on warranties given their widespread use in the industry. However, I will touch on a couple of the more recent cases and issues which arise from them.

Common clauses and wording

“no greater liability”

31. It is common to see this type of clause in warranties:

The Contractor shall owe no duties or have any liability under this deed which are greater or of longer duration than that which it owes to the Developer under the Building Contract.

32. The intention is that the contractor is at no greater risk under the warranty than he is or would be under the building contract.
33. This meaning of this clause was considered in *Safeway Stores Ltd v Interserve Project Services Ltd*.¹⁰ In this case Chelverton Properties Ltd were property developers who were to design and build a new store for Safeway. Chelverton entered into a building contract with Interserve. Interserve entered into a warranty directly with Safeway and Chelverton. A dispute arose about defects in the surface of the car park but this was settled between Chelverton and Interserve as part of the final account but Chelverton became insolvent and so never paid Interserve the settlement figure of £1.2m. Safeway, having incurred in excess of £400k in remedying defects in the car park then sought to recover these from Interserve under the warranty. As soon as Interserve received this claim it sought to set off amounts it was owed by Chelverton against what it owed to Safeway.
34. Interserve successfully argued that clause 3.3 was intended to prevent Interserve having a liability greater to Safeway than it had to Chelverton and therefore included rights of set-off.
35. Essentially, the issue boiled down to whether the risk of Chelverton’s non-payment was picked up by Safeway or Interserve. It was clear that under the wording of clause 3.3 this risk sat firmly with Safeway.
36. It is for this reason that beneficiaries frequently amend these types of clause so that rights of set-off are excluded - the argument being that the fact that the main contractor has not paid its subcontractor should be of no concern to the beneficiary of the warranty. This clause should always be checked if you are the beneficiary of the warranty because the chances are that a claim is being brought under the collateral warranty precisely because the main contractor is insolvent.

The meaning of “costs” in a warranty

37. Many warranties are drafted by employers’ solicitors and so, unsurprisingly, are drafted in wide terms without any restriction on the type of losses recoverable. However, occasionally warranties are drafted in more narrow terms, and in the Scottish case of *Glasgow Airport Ltd v Kirkham & Bradford*¹¹ the meaning of the word “costs” in a collateral warranty was considered.
38. The case arose from defects in a concrete floor slab and the airport owner sued Kirkham & Bradford (the engineer) under the terms of a collateral warranty it had received. The warranty contained a net contribution clause which limited the liability of the engineers to “that proportion of

10. [2005] EWHC 3085 (TCC)
11. [2007] CSIH 2007 SC 742

the costs that would be just and equitable for the engineer to pay". The engineers argued that the word "costs" instead of the words "damages, losses" etc. must have been used for a reason and that was to refer only to the costs of repair (i.e. out of pocket expenses) and not to cover all foreseeable losses which could flow from a breach. The court held that the engineer's liability for costs within the meaning of the warranty was to be given a wide meaning and covered all losses directly caused by the breach but subject to the ordinary common law rules of remoteness as set out in *Hadley v Baxendale* etc.

39. Although this is a Scottish case, and so not strictly binding in England and Wales, the moral of the story is clear. Any attempt to restrict the type of loss recoverable under a collateral warranty must be done with clear words, and trying to artificially construe the meaning of particular words to the detriment of the beneficiary of the warranty may get little sympathy from the court. This type of specific wording can be found, for example, in the JCT collateral warranty¹² which provides various options for the types of loss recoverable. Clause 1 provides:
- 1.1.1 the Contractor shall be liable for the reasonable costs of repair, renewal and/or reinstatement of any part or parts of the Works to the extent that the Purchaser or Tenant incurs such costs and/or the Purchaser or Tenant is or becomes liable either directly or by way of financial contribution for such costs; and
 - 1.1.2 where the Warranty Particulars state that clause 1.1.2 applies, the Contractor shall in addition to any costs referred to in clause 1.1.1 be liable for any other losses incurred by the Purchaser or Tenant up to the maximum liability stated in the Warranty Particulars.
40. The warranty then goes on to say that where clause 1.1.2 does not apply the contractor is not liable for any losses other than those referred to in clause 1.1.1 (i.e. the repair costs).
41. One point to bear in mind with this wording is that if only the first paragraph applies then the contractor has no liability for any diminution in value if the defect cannot be repaired. It would also probably exclude any investigation costs to establish the cause of the problem and the cost of vacating the premises. The beneficiary of the warranty containing only the clause 1.1.1 wording can find himself in the position of having a building which is defective (and therefore worth less) but because it cannot recover the consequential costs of having the work put right (i.e. loss of profit, etc.) is left suffering the diminution in value. The beneficiary of a warranty containing this wording should remind the contractor/consultant giving the warranty that it is likely that their PI policy would cover this consequential loss in any event. The commercial compromise is therefore to consider a cap on the amount of loss recoverable rather than restrict the category of loss.

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