THE CONSTRUCTION BAR ASSOCIATION OF IRELAND

Performance Bonds in Construction Contracts

1. **Overview**
2. **Disclosure obligations- uberrimae fides?**
3. **During construction- disputes arising**
4. **Calling in a bond**
5. **Summary Judgement**
6. **Arbitration**
7. **Bondsman's Defences**
8. **Conclusion**

1. OVERVIEW

1.1 Performance Bonds

Performance bonds are discretionary inclusions in construction contracts where the decision to require a performance bond will be made by the employer prior to the tendering process and every tenderer will be made aware of the need to provide a performance/surety bond if ultimately awarded the contract. The Contractor, having been awarded the construction contract, will then approach a Bank or financial institution and request a performance bond. The bank will request all relevant information to satisfy itself that the contractor has the ability to carry out the contract before committing to the provision of a bond. Some bond providers may also seek collateral security from the contractor for the provision of the bond.

Surety bonds typically involve three parties, the employer in the construction contract, the contractor engaged to carry out the works in accordance with the terms of the construction contract and the bondsman or guarantor who agrees, in return for the payment of a fee by the contractor to provide a bond to the employer. A performance/surety bond is essentially a guarantee given by a third party, usually a bank, to an employer that in the event of default or breach of contract by the contractor in the performance of the construction contract, the guarantor will pay damages to the employer up to the monetary level of the bond. The

purpose of the performance bond is to secure a beneficiary in an international construction contract against the contractor being unable to properly complete the project[1]. An ability to complete may arise for many reasons. Primarily it will occur due to contractor insolvency.

It was common in Ireland for the Bond value to be approximately 10% to 25% of the value of the construction contract in connection with which it is being provided. Typically, lower value contracts require a higher percentage of the contract value to be covered by the bond. Recently, due to the large number of contraction companies which have become insolvent, bond providers have reduced the amount of cover provided. Arising from the reduced cover available from banks, by circular No. 07/13 dated 1st May 2013, the Department of Public Expenditure and Reform informed all State Agencies of revisions with regard to the requirement for performance bonds on public works contracts. The changes took effect from the 1st May 2013 and provide that bonds should only be required on contracts valued in excess of €500,000. Up to €10 million a bond of 12.5% of the overall contract value should suffice. For Contracts in excess of €10 million 10% bonds should be sufficient. This represents a significant reduction from the percentage which were generally required for public contracts and brings Ireland in to closer conformity with the requirements in UK public works contracts.

1.2 The usual terms

The usual terms of a performance bond will include the following:

(i) In the event of breach of the Contract or default[2] by the Contractor, the Guarantor/Bondsman shall satisfy and discharge the damages sustained by the Employer as established and ascertained in accordance with the provisions of the Construction Contract in respect of which the bond is being provided.

(ii) The maximum aggregate liability of the Guarantor to be limited to a specified sum, usually 10% of the contract value.

[1] Per Keane J. in Hibernia Meats Ltd. v Ministre de L'Agriculture H.C. Unrpt. 16 Feb. 1984.
[2] If *default* is used in the bond wording, it has been held to be wide enough to cover a failure to comply with all obligations under the contract even if such default is not in a strict sense a breach of contract. For example where a contract terminates automatically on an insolvency event, there may not be a breach of contract by the contractor, but there is default. See Northwood Development Ltd v. Aegon insurance Ltd (1993) 66 BLR 72

(iii) The expiry date of the bond. This is usually expressed to be 12 to 18 months after practical completion of the contract works. Practical completion will be further defined by the Construction Contract.

(iv) The Employer shall notify the Guarantor of any default or breach of contract on the part of the Contractor as soon as possible, but not later than a fixed period of 30/60/90 days after the Employer become aware of the breach or default on the part of the Contractor in the performance of its obligations in accordance with the Construction Contract.

(v) Other clauses typically include a Jurisdiction clause, an exceptional event clause excluding liability in case of war/natural disaster etc and a clause providing that the bond validity shall not be effected by normal alterations made to the Construction Contract.

Significantly, arbitration clauses are not commonplace in performance bonds, this will be dealt with further below. Although it may not be included in the terms of the bond, where the bondsman pays out to the employer on foot of the contractor's default, it will have an immediate implied right of indemnity against the contractor. In practice, this may not be very useful as the contractor's failure to perform its obligations under the main contract will often flow from insolvency.

1.3 Other common types of construction bonds

In construction contracts in Ireland, there are two other reasonably common bond types. The first one is known as a bid bond whereby each tenderer provides a bond to the employer to guarantee that it will enter into the construction contract if the contract is awarded to them. Then if the successful tender does not enter in to the construction contract with the employer, the employer has a certain level (usually 3-5% of contract value) of compensation available to cover the cost of delay due to having re-run the tender the process to source a contractor. The second reasonably common bond is a retention bond provided by a contractor to an employer as a form of insurance to the employer against defects arising during the defects liability period. It is used to replace retention monies or a portion of retention monies.

1.4 Hybrid bonds

The distinction between an on demand bond and a surety/performance bond may not always be entirely clear. In the difficult case of IEI Contractors Limited v. Lloyds Bank and Rafidain Bank Limited[3], the Court of Appeal considered a bond which obliged the surety to pay "on demand" following a default by the contractor. Despite the reference to "default", the Court of Appeal considered that the use of the words "on demand" created a presumption that the instrument was an "on demand" undertaking and that, for the purposes of enforcement, the employer's written demand incorporating an assertion of default would suffice. This case illustrates the importance of the bond wording in determining whether the bond is an 'on demand bond'[4] or a conditional bond of the type covered by this paper.

1.5 Older form traditional performance bonds

The wording and form of performance bonds which used to be commonplace in construction contracts was unusual and the subject of a great deal of judicial criticism being described as archaic and unnecessary convoluted jargon. Rather than containing a straight forward guarantee of the third party's obligations, traditional performance bonds contain a statement by the guarantor that it is bound to pay a specified sum to the beneficiary of the bond. The bond then goes on to contain a condition providing that the bond becomes void on the fulfilment of the particular third party obligation the performance of which it is intended to secure. In essence, the contractor's liability under the bond is not expressed as a positive covenant by the bank to guarantee the performance of the contractor obligations, but, rather, is expressed in terms which state that, if the contractor fulfils its obligations the bond becomes void (with the result that the liability to pay the sum specified in the bond ceases).

The traditional form of bond remains in use notwithstanding the degree of criticism of the form and wording. The principles applied where the traditional form is used rather than the more modern form described at 1.2 above, are very similar.

2. PRE- BOND DISCLOSURE

[3] (1990) 2 Lloyd's Rep. 496

[4] To claim on an 'on demand' bond, demand is simply made in accordance with the terms of the instrument. If that is done and in the absence of fraud, the amount of the bond must be paid. This is so even where a court is satisfied that the employer/beneficiary is acting oppressively or is itself in breach of contract.

2.1 The law in relation to disclosure at the time of entering in to a bond is much less evolved that the law relating to disclosure in insurance contracts. In *Trade Indemnity v. Workington Harbour*[5] the Court held in favour of enforcing compliance with a bond where prior to the entry in to the bond the contractor was given two opportunities to withdraw its tender on the basis of groundwater issues which were not disclosed to the bondsman. The bondman sought to argue that the performance bond was in reality a contract of insurance as between the contractor and bondsman. As such it argued that the excessive groundwater, inadequacy of the tendered contract price and offers of withdrawal should have been disclosed to it prior to the entry in to bond. The House of Lords found that the fundamental nature of the performance bond was a contract of guarantee and not a contract of insurance. In relation to the disclosure obligations of a contractor, Lord Atkin stated at p18:

For myself I doubt on the course of business alone whether a guarantor looks further than the skill and experience of the contractor to guard against risks of unknown difficulties in the performance of such a contract. That seems to accord with the evidence of Mr. Patrick, the manager and contractor of the defendant company. The guarantors are in such a case primarily concerned with the financial ability of the contractors to complete this contract whether it result in a loss or not.

2.2 It is clear from the decision that there is no special duty on a contractor to disclose normally encountered construction project hazards to the bondsman prior to or during the performance of the contract. In the *Trade Indemnity* case, the Court placed significant weight on the fact that the contractual documentation for the construction contract was all incorporated into the guarantee given and therefore the bondsman was taken knew the contractual provisions which disclaimed any responsibility on the part of the employer for ground conditions. In an appropriate case involving a failure to disclose an unusual risk in a particular contract, the issue may be worthy of future consideration. However, it is more probable that the issue will arise in a case where a contractor supplies misleading financial information to a bondsman to procure a bond and subsequently becomes insolvent. In *Hudson* at p1355, the author states:

[5] [1937] 1 AC 1

It is submitted that the Trade indemnity case rightly shows that in the case of a due performance bond or guarantee of a construction contract this can only happen on very unusual facts, and that the reality of construction contracts in particular is that eventualities such as unfavourable physical conditions or hazards, or instances of under-pricing by bidders, are such a commonplace as to call for no special duty by employers to warn a guarantor.

3. DURING CONSTRUCTION

3.1 In order for an employer to make a claim on performance bond, it will have to establish a breach of the Contractors obligations under the main Construction Contract. Usually, an insolvency event will be the trigger for the employer to make a claim on the bond as the Contractor is not in a position to complete. However, the situation becomes much less certain where disputes arise between the Employer and the Contractor during the course of the Contractor's performance of the contract. For example, in a situation where a Contractor has been guilty of persistent delays, defective work on site and an apparent inability to deliver on its obligations to the Employer, can the employer make a claim on the performance bond?

3.2 There is no bar in the wording of most bond forms which would prevent an Employer from seeking to call in a bond during the course of an ongoing contract, but it would be unusual for that to occur while the contract was ongoing as the Employer would ordinarily deal with the contractor in accordance with the construction contract rather than making a call to be compensated by the bondsman. An employer does not have to wait until the precise and full amount of the damages it has suffered are calculated before seeking recovery. Provided it can show it has suffered damages over the bond value, the employer is not bound to wait until the entirety of claim is quantified and capable of substantiation. However, if adopting the approach of seeking immediate payment of the bond value, an employer would be well advised to ensure that there are no express terms of the construction contract which operate so as to defer the contractor's liability or the quantification thereof until a later point in the construction

contract. This could dis-entitle the employer to claim for damages until a specific time (eg practical completion or the end of the defects liability period)[6].

3.3 Where a Contractor has been guilty of a fundamental breach at common law or guilty of conduct allowing the employer to terminate the construction contract and order the contractor offsite, the employer could then claim on the performance bonds for all costs, expenses and contract price uplift caused by the Contractors default. In that scenario, the employer would have to demonstrate that it terminated the contract validly in accordance with the contract or at common law[7]. If the bondsman wishes to dispute the right of termination exercised by the Employer, it can step in to the shoes of the contractor for that purpose and defend the alleged right of the Employer to claim on the bond. In all calls made on a performance bond, the bondsman may rely on the terms of both the bond and the underlying contract to dispute the entitlement of the employer to be paid damages in accordance with the bond. All defences which would have been available to the contractor may be advanced by the bondsman. As a result, litigation is a strong possibility where there is a dispute between the employer and the contractor regarding any matters the subject of the contract (eg. delays, payment, site conditions, termination).

4. CALLING IN A BOND

4.1 An employer seeking to recover on a performance bond may proceed to recover damages upon a default of the contractor immediately and directly from the bondsman without notice to the contractor[8]. The first condition to be complied with in order to make a call on the bond are those conditions contained in the bond itself. They are usually reasonably straightforward and involve making a demand in writing during the currency of the bond as soon as possible after a breach of contract or default on the contractor. The letter of demand should state in broad terms the breach

[6] This occurred in Paddington Churches Housing Association v. Technical and General Guarantee Limited (1999) BLR 244, where the Court regarded the claim as premature.

[7] See Galway City Council v. Samuel Kingston Ltd [2010] IESC 18, O'Donnell J, for an excellent analysis of common law repudiation of construction contracts. "*Repudiatory breach is not so much concerned with the manner in which a breach is carried out, as with the significance of the obligation breached. It is difficult to conceive those circumstances where it could be said that notwithstanding abandonment of the site a contract still existed so that the employer must continue to perform it and would be left to its remedy in damages."*

[8] See Moschi v. Lep Air Services [1973] AC 331, caution must be exercised though to ensure the claim is not deferred in accordance with the contract.

of contract on the part of the contractor and the damages, or an estimate thereof, suffered or to be suffered as the result of the breach. The important thing is that the letter leaves no doubt in the mind of the recipient that there is a call being made on the bond and the reason, in general terms, why such a call is being made[9].

4.2 The issue of greater importance is how far an employer must go to prove a breach on the part of the Contractor. In Tins Industrial Co Ltd v Kono Insurance Ltd[10], the employer obtained summary judgment against the bondsman, which was set aside by the Hong Kong Court of Appeal. Hunter JA at p121 stated:

In our judgment therefore the trial judge was wrong to say that he could disregard the underlying contract. This is in our view a case where a claimant under the bond has to prove first breach, and secondly damages.

4.3 The last part of that passage was cited with apparent approval by the House of Lords in Trafalgar House Construction (Regions) Ltd v General Surety and Guarantee Ltd[11]. In that case also summary judgment had been obtained in an action on a bond in substantially identical terms to that in the Tins case. It was set aside by the House of Lords. Lord Jauncey, with whom the other members of the House agreed, said immediately following his reference to Tins:

My Lords, I have no doubt that the Court of Appeal were in error in concluding that the bond was not a guarantee but was akin to an on-demand bond. No distinction can, in my view, properly be drawn between the effect of this bond minus the second part of the condition [Condition (b) above] and the bond considered by Lord Atkin in the Workington case [1937] AC 1, 17 and other bonds using this or similar wording have for many years been generally treated as guarantees .... . [After quoting from the speech of Lord Atkin in Workington Harbour Dock Board v Trade Indemnity Co Ltd (No 2) [1938] 2 All ER 101 he continued:] This dictum makes it clear beyond doubt that proof of damage and not mere assertion thereof is required before liability under such a bond arises.

[9] In Frans Maas (UK) Ltd v. Habib Bank [2001] Lyoyd's Rep. Banking 14, an issuing bank was not obliged to accept notice of a demand where it was vague and ambiguous.
[10] (1987) 42 BLR 110
[11] (1995) 73 BLR 32

I have therefore no hesitation in concluding that the .... bond without the second part of the condition would amount to a guarantee and that the [bondsman] would be entitled to raise all questions of sums due and cross-claims which would have been available to [the contractors] in an action against them for damages. (page 41D)

4.4 The effect of the requirement to prove breach and damage is vital in all performance bond related litigation. The Employer is put in no better position as if the claim was being made against the Contractor itself save for the certainty of knowing that if it is successful, there will be sufficient funds to meet the claim up to the bond value.

5. SUMMARY JUDGEMENT

5.1 Suing on foot of a bond will generally occur where the bondsman seeks to refuse to pay out following notice of the claim being made by the employer in accordance with the terms of the bond. Where proceedings are necessary, summary proceedings will often be the most appropriate procedural route to proceed for an employer seeking to recover on a performance bond. The amount sought will be a liquidated sum and in many cases the damages due to the employer for the contractor's breach of contract will be far in excess of the recoverable bond value. Where the damages are greatly in excess of the bond value, issues of cross and counterclaims are unlikely to be of great concern as there will be a significant element of 'head room' between the bond value and the damages the employer would be entitled to[12]. As stated 4.1 above, there is no obligation to join or involve the contractor in such proceedings and as a result, the bondsman's right of indemnity as against the contractor is a matter for separate proceedings seeking indemnity.

5.2 Although summary proceedings appear to be appropriate for cases involving damages which greatly exceed the amount of the bond value, there will be many types of cases where oral evidence will be required to prove the contractor's breach of contract in the event of a dispute and/or to prove the damages suffered by the employer as a

[12] Nene Housing Society v. National Westminster Bank (1990) 22 BLR 22 where the damage caused before an insolvency event exceeded the bond value so the absence of an architect's final certificate under the contract was immaterial to the employer's claim on the bond.

result of the breach of contract by the Contractor. In any case where there would have been a triable issue regarding breach and damage as between the employer and the contractor, there will similarly be triable issue as between the bondsman and the employer as the bondsman steps in to the shoes of the contractor for the purpose of the Court's determination of whether there was a breach of contract by the contractor entitling the employer to damages.

5.3 In a summary Judgement application in in Trafalgar House v. General Surety [1996] 1 AC the bondsman's expert evidence[13] challenged the employer's heads of claim generally and demonstrated possible claims by the contractor. At first instance, leave to defend was denied and the Court granted summary judgement to the employer. However, on appeal the House of Lords decided that in order to establish liability under the bond proof of damage was required and mere assertion was insufficient. The appellants were therefore entitled to raise the questions of the sums due to the subcontractor and its cross-claims and that there was sufficient evidence to raise a triable issue in relation to the heads of claim. Leave to defend was granted to the contractor.

5.4 There is a tactical issue which may arise in proceedings, whether summary or plenary, regarding the right of an employer to claim on bond. The issue is that the bondsman may be at disadvantage concerning the actual operations on site and will require the assistance of the contractor in advancing any defence which it may have to refuse to pay out on the bond. In an insolvency scenario, there will be little incentive for a contractor to devote resource to providing information, instruction and/or documentation to the bondsman to allow a full defence to be mounted. There is likely to be a 'full co-operation' provision in the contractual documentation between the contractor and the bondsman at the time of the issuing of the bond, but one must wonder, on a practical level, how useful such a clause would be to the bondsman where a contractor becomes insolvent.

6. ARBITRATION

[13] Provided on affidavit as it was a summary judgement application.

6.1 In most performance bonds, the bond will not specify the mode of dispute resolution. Some bond forms do provide for a third party determination of default by an independent architect of engineer[14], but the majority of performance bonds are silent on how disputes between the employer and the bondsman are to be resolved. It would appear to be sensible that bonds would include a provision providing that any dispute as to a claim on the bond would be dealt with in same manner as disputes arising under the main construction contract because the bondsman can raise all the defences available to the contractor.

6.2 Where an arbitration has taken place between the employer and contractor under the provisions of the construction contract, a bondsman (in the absence of a provision to the contrary in the bond) will not be bound[15] by the outcome of such an arbitration because the right of recovery on the part of the employer under the terms of the bond is a separate and distinct right of action from the employer's right of action against the contractor[16].

6.3 However, if a bondsman was to undertake to be bound by the result of an arbitration conducted between the employer and the contractor, a Court may well take the view that a stay would be appropriate pending the outcome of the arbitration to prevent parallel processes regarding the same liability.

7. BONDSMAN'S DEFENCES

The primary defences to liability to an employer on foot of a performance bond are as follows:

(i) Failure of employer to make a demand under the bond as soon as reasonably possible;
(ii) Failure to abide by a time limit in the bond for the making of a claim under the bond;
(iii) Failure to specify the alleged breach of contract within time/when making demand;
(iv) Failure of contractor to disclose an unusual feature of the main construction contract;
(v) That the contractor was not in breach of contract;

[14] See Obedrect Oil & Gas v. North Sea Production Co Limited [1999] 2 All ER 405
[15] Re Kitchin (1881) 17 Ch D 668
[16] Hudson, p1321, para 10-048

(vi) Cross claim/counter claim of the contractor equalling or outweighing employer's claim;

(vii) That no damage has been suffered or at least not as much as the bond value;

(viii) Failure to mitigate losses;

(ix) Fraud in the taking out of the bond; and

(x) Employer repudiation of the main contract by ordering contractor off site or retaining alternative contractor.

8. CONCLUSION

The primary source of the legal duties and responsibilities of the parties to a performance bond is the bond itself. While this paper attempts to give a broad outline of the law of performance bonds, every bond is different and each bond should be analysed in detail by practitioners prior to making a decision on how to claim or resist a claim on a bond. If advising on how to claim on a bond, it is important to make the initial notification/demand in accordance with the terms of the bond as to time, manner of demand and to set out the breach of contract claimed. Thereafter it will be a matter of quantifying the damages to be claimed arising from the breach of contract. In most cases, assuming the bondsman does not pay out, issuing summary proceedings will be the next step. Thereafter if a *bona fide* defence is raised by the bondsman, the matter will proceed to plenary hearing where the two essential proofs will be breach of contract and damage. At all points in the process the bondman may raise all of the defences which would have been available to the contractor, both in relation to the existence of breach of contract and the damages occasioned by such a breach.

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