

Construction Law

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Shaken not stirred - Know your Bond!

Performance bonds protect employers against contractor default, non-performance or insolvency. However, many employers wrongly assume that a bond provides an insurance policy which automatically pays out in such circumstances. This is rarely the case and it is crucial to check carefully the circumstances under which a claim can be made.

An introduction

Typically a building contract is supported by a separate bond with a third party bondsman who promises to be responsible for any default by the contractor under the building contract. There are two basic forms of performance bond: "on-demand" bonds and "default" bonds (or "conditional bonds"). Most common is a default bond.

A "default bond" requires the bondsman to pay out when it is proven by the employer that the contractor has breached its obligations under the building contract and that it has suffered a loss as a result of this breach. The employer must be able to prove that it has suffered the losses claimed, which would normally need either (1) written agreement from the contractor that the employer has suffered the loss or (2) a decision of an adjudicator, court, expert or other third party determiner allowed by the terms of the bond. The bondsman is entitled to the same defences as would be available to the contractor under the building contract.

Is insolvency an event of default?

A contractor's insolvency will not always entitle the employer to call on a bond. It usually requires express wording in the bond in order to do so. This is because

the liability of the bondsman is tied to the underlying building contract, but in most forms of building contract (including the 1998 and 2005 editions of the JCT Standard Forms) the insolvency of the contractor is not treated as an "event of default", rather just an event entitling the employer to terminate the contract. This is not always the case though – for example, the ICE Forms do treat contractor insolvency as an "event of default" and give the employer a right to claim damages from the contractor as well as to terminate the building contract.

The authority for this "no breach" principle is Perar v General Surety and Guarantee Company Limited [1994]. The building contract contained a clause stating that the contractor's liquidation would lead to termination of the contract (which is what happened). The bond, however, said that payment would be made only in the event of a breach of the building contract. It was held by the Court of Appeal that as insolvency was not a breach of the building contract, there was no automatic right for the employer to claim under the bond. In addition, the termination of the contract relieved the contractor of any further obligation, so there was no breach of contract (e.g. failure to carry on with the works) and therefore no requirement for the bondsman to pay anything under the bond.

Common problems in enforcing the bond prior to completion of the works

So can an employer call on a bond in order to make payments to a replacement contractor so as to complete the unfinished works?

The case of Tower Housing Association Limited v Technical and General Guarantee Company Limited [1997] established that it requires a clear contractual mechanism in order to ascertain the amount of damages suffered prior to completion of the works. In this case, the performance bond provided that:

"In the event of the determination of the Contractor's employment under the Contract for reasons of insolvency [the bondsman will] ... satisfy and discharge the net damages sustained by the Employer as established and ascertained pursuant to and in accordance with the provisions of the Contract".

The bond also stated that:

"nothing herein contained shall oblige the Employer to await the completion of the Works prior to making any proper demand hereunder".

Despite this wording, it was held that the amount of damages to be recovered by the employer under the bond had to be “*established and ascertained pursuant to and in accordance with*” the building contract. The fact that the final account for the completion of the works had not been concluded meant that the employer was not able to make a “*proper demand*” prior to completion of the works.

In [Paddington Churches Housing Association v Technical and General Guarantee Company Limited \[1999\]](#), the performance bond stated that the net established and ascertained damages sustained by the employer would be payable where there was a valid termination of the building contract. However, the bondsman was still able to avoid payment following the contractor’s insolvency. The bondsman successfully argued that the employer had not calculated and specified its net damages before claiming, so the monies were not payable until this had been done.

These two cases mean that an employer may be prevented from converting the bond into funds in order to pay a replacement contractor to complete the finished works, leaving the employer to fund the remaining works until the final account has been established. A further problem with this is that the final account may not be concluded until after the expiry of the performance bond (for example, if the bond is due to expire on the date of practical completion). This may also be the case where a bond requires an award or judgment to accompany the employer’s demand - if

proceedings are protracted, then the bond may have expired prior to the conclusion of the proceedings.

Matters may be further complicated by the fact that legal proceedings cannot be commenced against contractors in administration or liquidation without the permission of a court (or, in the case of administration, the consent of the administrator).

Possible solutions

To address this, a bond will typically need to qualify the expiry date so that the bond remains in force where a breach of contract or insolvency has occurred prior to the expiry date and where a notice to this effect has been sent to the bondsman prior to the expiry date (usually specifying that the proof of breach and/or establishment of the employer’s loss is not yet capable of determination). This then reserves the employer’s right to claim under the bond until such date as the demand on the bond can be properly quantified.

In addition, to counter the risk of insolvency, there is increasing use of a mechanism whereby the amount of an employer’s loss can be deemed established prior to completion of the works on a reasonable independent pre-estimate by an expert (usually a quantity surveyor) of the amount likely to be due under the bond. Such a mechanism would typically include an adjustment mechanism whereby if the final liability exceeds the pre-estimate, there may be a further claim against the bondsman, and if the bondsman has overpaid due to an

excessive pre-estimate, an amount can be paid back to the bondsman. However, this method is so far untried in the courts.

Conclusion

It is easy to assume that the issue of a performance bond will give complete protection to an employer in the event of default, non-performance or contractor insolvency. In fact, the wording of “default” bonds must be carefully considered, including the circumstances under which the employer is entitled to call on the bond and the mechanisms by which the employer can ascertain the loss suffered, particularly where an employer may wish to call on the bond in order to fund the employment of a replacement contractor to complete the works.

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‘A compact but energetic team led by Jane Ryland takes a proactive approach to ensuring clients receive the service they require’

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