Performance Bonds

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In the context of construction contracts, a performance bond may be described as a species of security which offers an effective legal and financial safeguard in the form of a guarantee which, at the request of a contractor, is furnished by a third party (ordinarily a bank or insurance company), to a project's employer/principal, whereby the former undertakes that payment of a pre-determined sum, representing a prescribed percentage of the value of the works to be executed, shall be duly effected, in favour of the employer, in the event that the contractor shall default in the performance of his contractual obligations.

The particular nature of this form of security device will dictate the circumstances in which it will be triggered with a view to effecting payment. In this context, a conditional bond will oblige the employer to substantiate his contention that he has suffered loss in consequence of the contractor's default in discharging his contractual undertakings. In this respect, it is pertinent to point out that according to applicable case authority, a surety could conceivably avoid incurring liability in circumstances where variations to the underlying contract had been duly agreed upon and effected by the employer and contractor without having obtained the surety's prior consent.

As regards 'on demand' bonds, and in contrast with the characteristics and implications of those that are regarded as conditional, the employer is at liberty to seek payment from the surety by simply notifying him to the effect that the contractor has failed to discharge his contractual obligations (such notice being subject of course to any specific procedural stipulations or prescribed requirements as to form). Pursuant to this, the relevant funds would subsequently be released in favour of the employer, irrespective of whether the contractor contests or disputes the employer's assertion that the former is in breach of his contractual obligations. In light of this, the contractor's position is, needless to say, a precarious one which carries with it a significant element of risk that the relevant provision of the bond will be relied on, notwithstanding the fact that this may be vigorously opposed by the contractor who may conceivably refute the allegation that he has failed to honour his contractual commitments.

Whilst the foregoing may, insofar as it relates to the categorisation of performance bonds, appear to be a relatively straightforward matter, the legal position may well indicate otherwise. On the face of it, the payment mechanisms of an 'on demand' bond would literally leave the contractor with no room to manoeuvre, once he receives appropriate notification from the employer. However, it would appear that there is an inclination by the courts to go behind the often misleading descriptive label ascribed to this form of security and to afford due consideration to the substance thereof, in order to determine its true nature and effect. Accordingly, the issue may not simply be perceived as a terminological one, but rather as one of construction whereby the obligation to effect payment under an on demand bond, might not necessarily be triggered by due notice being given on the part of the employer. Indeed, judicial reasoning appears to have leaned towards declaring that a rebuttable presumption arises to the effect that a bond will not be regarded as capable of being activated on demand unless, on a proper interpretation of the terms of the operative bond document, there is an unequivocal indication to the contrary (*Vossloh Aktiengesellschaft v Alpha Trans (UK) Limited [2010] EWHC 2443 (Ch)*endorsing the court's approach in *Marubeni Hong Kong v Government of Mongolia [2005] EWCA Civ 395*). Not surprisingly, it is firmly established, that in circumstances where the employer has acted fraudulently (where the court is of the opinion that he, as beneficiary, had no honest belief that he was entitled to payment), there will be no legal entitlement to security funds. In cases other than deceitful conduct, it was initially believed that the degree of proof required, on the part of the contractor, in order to resist the employer's demand for payment through injunctive relief, was that it should be "positively established" that the employer was not within his rights to do so. Whilst this proposition was formulated and adopted in earlier case law, recent judicial authority has opted for a more diluted position which aligns itself and is compatible with established principles governing interim injunctions, whereby a "strong case" would appear to suffice to halt the activation of bond's operative payment provision, pending final determination by the competent court *(Simon Carves Ltd v Ensus UK Ltd [2011] BLR 340)*.

It is evident from the foregoing, that once it is established that a bond may be triggered to activate payment on demand, the relevant funds will thereby be released by the surety without proof of any violation of the underlying contract. However, in this context, a further question arises as to the extent to which the employer, as designated beneficiary of the security funds, shall thereby be entitled to enjoy, to the full extent of the bond's stipulated value, the fruits of payment thereunder, irrespective of the actual monetary loss incurred by him. In other words, an issue necessarily arises as to whether the employer should, following receipt of the security proceeds, be duly restricted to retaining only such portion of the total amount paid which properly represents his actual loss and accounting for the balance/surplus, if any, to the contractor). In this regard, the position would appear to be that unless there is clear contractual wording to the contrary, it will be incumbent on the employer/beneficiary to account (if the security funds exceed his actual loss), and thereby retain only that portion of the payment which corresponds to the actual loss occasioned by the contractor's default *(Comdel Commodities Ltd v Siporex Trade SA [1997] 1 Lloyds Rep 424)*. Once again, it is evident that the issue of construction of the underlying contract has a pivotal role to play in determining the precise nature of the parties' respective rights and obligations.

The issues addressed herein serve as a further reflection of the importance of obtaining expert advice in relation to project security requirements which are ordinarily encountered in the construction sector. In particular, the various aspects considered in relation to performance bonds should alert the participating parties to a contract that such documents ought not to be simply viewed at face value and that appropriate professional guidance should be sought as to how to avoid unnecessary legal risks and potential financial pitfalls that might otherwise arise.

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