Bonds

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It is now customary, and has been for several years, for employers in Hong Kong to request bonds to be provided by their main contractors. The usual types of bond in use in Hong Kong are:

(i) performance bonds (or conditional bonds); and

(ii) on-demand bonds (or unconditional bonds).

Bonds have often been criticised for using archaic language (Keating paragraphs 10-40) but there are no reasons why bonds cannot be drafted using modern language. For instance, the bonds used with the Swire standard form of contract have modern language and are drafted as deeds, which gives them certain legal significance.

For further legal information on bonds, reference can be made to paragraphs 10-41 to 10-47 of Keating 6th edition.

Just as a main contractor provides a bond to an employer, then a main contractor looks to protect its interests by obtaining bonds from their sub-contractors. Again, such bonds are either conditional or unconditional and are often based upon back-to-back wording used in the main contractor's bond.

In recent years, it has also become fashionable for employers to obtain bonds directly from nominated sub-contractors. Hence, an employer may have the same work bonded twice, once through the main contractor and the second time through a nominated sub-contractor. However, if an employer chooses to do this double bonding then beware that the traditional reliance upon there being no privity of contract between an employer and sub-contractor is brought into question by such a bond. Further, if an employer makes a demand upon a sub-contractor's bond for alleged default then the employer has established that there is some form of contractual relationship between it and the nominated sub-contractor. If such circumstances were to arise, and there were disputes between the employer and main contractor, then the main contractor would be well advised to seek legal advice.

Whatever type of bond is selected by the employer and incorporated into the contract, to ensure that the main contractor actually delivers what it has contracted to deliver, it is recommended that the delivery of the bond is made a condition precedent to the first interim payment, so that the first interim payment is not released until either the bond is delivered or the bonded sum has been accumulated and can be retained as security for the delivery of the bond.

1. A typical clause

The following is typical wording for a clause in a main contract requiring the main contractor to provide a bond. The clause covers three important aspects of the bond, namely the amount (the bonded sum), the type of bond (as set out in an appendix) and the expiry date (the final certificate).

"The Main Contractor shall within seven (7) days of acceptance by the Employer of this Tender deliver the Main Contractor's Performance Bond duly executed by such bank or other institution as the Employer shall have previously approved in writing in the amount stated in Appendix A to these Conditions and in the form appearing in Appendix C to these Conditions for the due performance of the Contract. The cost of obtaining such a bond is to be allowed for by the Contractor in the appropriate item in the Contract Bills. Provided always that when the Final Certificate shall have been issued the said bank or institution and the Main Contractor shall be released from such bond."

What should an employer ask for in terms of the length of the bond? The general rule is to avoid using a fixed date for the expiry of the bond in case of delays and prolongation. Usually, a bond terminates at, either the certified date of completion of the Works, or the certified date of completion of making good defects. However, some employers require bonds to run through to the final certificate (as in the clause quoted above), or the end of dispute resolution procedures.

2. Performance bonds

Performance bonds (or conditional bonds) are agreements whereby the surety (or bondsman) pays out if the contractor fails to perform. To succeed with a demand on a performance bond there must first of all be a failure to perform either admitted by the contractor or established as fact within the context of the bond and the master contract.

A demand under a performance bond can be challenged in the courts by the contractor, who will most probably argue that the cause of the alleged non-performance was an event or events for which, under the contract, the employer is liable and, therefore, the demand should not succeed as the employer cannot be allowed to benefit by its own misdeeds. Often, demands under a performance bond, which are challenged by a contractor, are set aside pending arbitration or a court case to decide who is responsible for the alleged non-performance.

However, if the employer wins the arbitration or court case then it can immediately resort to the performance bond and recover the maximum under the bond or the maximum award of the arbitration or court case (plus legal fees) whichever is the lower.

In recent years, performance bonds have been sidelined by employers in preference for on-demand bonds, however, performance bonds are still worth consideration on the basis that there is some ready access to funds when default is established or admitted.

3. On-demand bonds

Employers tend to prefer the on-demand type of bond (or unconditional bond) as it can be called upon without any proof of default and, provided that the demand is not raised vexatiously, maliciously or fraudulently, the contractor cannot object and the surety (or bondsman) will make payment under the terms of the bond.

What should employers look for in an on-demand bond? It is essential that the wording of such a bond is clear, crisp and direct. The effective clauses in an on-demand bond should be something similar to the following:-

1. *"The Surety hereby irrevocably and unconditionally agrees to pay to the Employer the Bonded Sum on the terms and in the manner hereinafter appearing."*

2. *"Upon receipt of a written demand by the Employer to the Surety stating that the Main Contractor has failed to discharge any or all of his obligations under the Main Contract and without being entitled or obliged to make any inquiry either of the Employer or of the Main Contractor, and without the need for the Employer to take legal action against or to obtain the consent of the Main Contractor, and notwithstanding any objection by the Main Contractor and without any further proof or conditions and without any right of set off or counterclaim, the Surety shall forthwith pay to the Employer the amount or amounts specified in such demand or demands, not exceeding in aggregate the Bonded Sum, it being confirmed that the Employer may make as many separate demands hereunder as it thinks fit. Such payment or payments*

shall be made by transfer to an account in the name of and at such bank and in such place as the Employer shall direct."

3. *"The Employer's demand made in accordance with Clause 2 shall be conclusive evidence of the Surety's liability to make payment hereunder and of the amount of the sums which the Surety is liable to pay to the Employer."*

As stated earlier, an employer should not make a vexatious, malicious or fraudulent demand on a bond. If a contractor gets advanced warning of a possible vexatious, malicious or fraudulent call on an on-demand bond then he can apply to a judge for an injunction preventing the employer from making a call on the bond. However, the employer can appeal against the injunction and, provided that he can show good cause to call on the bond, then the injunction will be waived and the call permitted.

History shows that even vexatious, malicious and fraudulent calls under on-demand bonds are often met by the surety. The reason why a surety does not question a call on an on-demand bond is often as much linked with the arrangement of the bond as it is with the wording thereof.

4. Funding on-demand bonds - through the contractor's bank

Large construction companies, whether they are main contractors or sub-contractors, can arrange funding for on-demand bonds through their bankers at a nominal direct cost but with a significant effect upon working capital.

The way in which such bonds are arranged is that the contractor has to maintain, on deposit with the bank providing the bond, an amount similar to the bonded sum plus a smaller amount to cover the bank's cost in processing a call on the bond. Hence, when a demand is made on the bond, the bank immediately draws on the contractor's deposit to meet the demand. The surety does not, therefore, lose out financially (but the contractor does) and bears an insignificant risk (contrary to the risk borne by the contractor). Hence, the surety's charges to a contractor for such bonding arrangements are relatively small.

A large contractor with substantial financial funds tied up in bonds often arranges through its bankers to maintain on deposit a portion of the total of the bonded sums on the basis that demands under all of the bonds will not all be made at once.

However, the capital lock-up caused by on-demand bonds is a significant drag upon construction finance and contractors could put that money to much better use and make higher profits if there were no such bonds.

Further, in a prolongation situation, the cost to the contractor of extending the bond is not just the fee charged by the surety but the cost of the money on deposit. In this respect, a contractor making 2.5% profit on turnover can, with proper financial planning, make about 20% on working capital. Therefore, money tied up in bank deposits to cover the risks in providing bonds actually costs the contractor the difference between what would be its return on working capital and the deposit rate given by the bank.

5. Funding on-demand bonds - through an insurance company

A contractor who does not have sufficient funds to arrange an on-demand bond through its bankers may be able to obtain an on-demand bond through an insurance company or some other financial institution.

The cost to a contractor of such a bond will depend upon its reputation, financial standing and ability to convince a third party to take the risk. Obviously, insurance companies who participate in providing on-

demand bonds do so in order to make profits on this type of risk business and the premiums can be very high.

A recent article in the UK magazine "Building" reported that, in the UK, it is now almost impossible to obtain on-demand bonds from insurance companies. That trend appears to be spreading to Hong Kong, particularly in the sub-contract market.

6. Does bonding work?

If an employer feels satisfaction and a degree of security in having a bond then the answer must be yes.

However, bonding costs the industry a great deal in unforeseen capital lock-up or excessive costs.

The usual Bonded Sum is limited to 10% of the original contract (or sub-contract) sum. Bonds are to protect the bondholder in case of default but, if things go seriously awry, then 10% is certainly insufficient recompense to cover the additional costs, which an employer may incur. In this respect, one then questions why an employer should have a bond with a 10% limit, or whether the bonded sum should be larger. Rather than increasing the bonded sum to say 20 or 25% to reflect the risks of serious mal-performance by a main contractor, a more pro-active approach to obtaining satisfaction and security is the selective choice of a contractor with a good reputation, a sound financial history and a realistic competitive price. This approach is to be preferred to the appointment of an unknown company that has slashed its price below cost but offers a 10% on-demand bond as security for its performance.

When it comes to main contractors, then through bonding from employer -> main contractor -> sub-contractor is a commercially unviable means of underwriting risk.

Take, for example, a $100,000,000 contract where the main contractor provides an on-demand bond for 10%, i.e. $10,000,000. The main contractor sublets a critical construction activity to a sub-contractor for $20,000,000, which the sub-contractor provides to the main contractor a 10% bond, i.e. $2,000,000. The sub-contractor defaults to the tune of $5,000,000 and the main contractor makes the maximum demand under the sub-contractor's bond and receives $2,000,000. The sub-contractor immediately goes into liquidation so the main contractor cannot recover the other $3,000,000. Under the main contract, the sub-contractor's failure causes the main contractor to default and the employer calculates the liquidated damages to be $14,000,000. The Employer makes the maximum demand on the main contractor's bond of $10,000,000 and retains the other $4,000,000 from payments otherwise due to the main contractor. The main contractor is, therefore, $17,000,000 out of pocket and with no means of recovery. Therefore, in this example, the main contractor's bond was of very limited use and the main contractor would have been far better off if he had chosen a reliable sub-contractor and managed the critical works in a more pro-active manner.

A far better solution to larger bonds, to ensure performance and minimise the risks of delay, are diligent management, the choice of the right contractor / sub-contractor, equitable risk sharing and an adequate price.

7. A demand upon an on-demand bond

As there is no contractual machinery under most contracts or bonds for a contractor to recover any demand made upon an on-demand bond, a demand by an employer upon such a bond is often the catalyst for a notice of dispute (arbitration) or the start of a court action.

In a recent instance, a main contractor made a demand on a $4m bond and this proved to

be the catalyst for a notice of arbitration whereby the sub-contractor claimed $50m, only to receive a counter claim from the main contractor for $300m. Of course, there was no guarantee that the arbitration would not have occurred had there not been a demand on the bond, but such demand, in that instance, was certainly the catalyst for the arbitration notice.

8. Other types of bonds

In addition to the usual bonds referred to at the start of this article there are retention bonds and advance payment bonds. These types of bonds are self-explicit.

In the UK, where a law was enacted to introduce adjudicators for deciding contractual disputes whilst work was still in progress, a recent development was the introduction of adjudication bonds whereby an adjudicator has to consider and decide upon the merits of any demand on such type of bond. This seems to be a step between performance and on-demand bonds but, obviously, an adjudicator can decide upon demands made under performance bonds, and, in the case of on-demand bonds, can order the refund of an illegitimate demand on such a bond.

9. The future of bonds

If contractors and sub-contractors began pricing in their tenders, the true cost of a bond, particularly on-demand bonds, then employers' attitudes to bonding may change. However, whilst contractors and sub-contractors make either low or no financial provision in their tenders for the delivery of a bond then there are no commercial reasons why employers should stop asking for bonds.

Further, whilst bonds can be arranged as described under the heading "*funding on-demand bonds - through the contractor's bank*" it appears that sureties will still offer on-demand bonds.

Conclusions

The wording of any bond, particularly an on-demand bond, should be clear, unambiguous and crisp in its obligations. An on-demand bond should be brief and contain no provisions that can be construed as conditional; otherwise it will be treated as a conditional performance bond.

A bond should not have a fixed expiry date in case of delays and prolongation. If a bond has a fixed completion date then the employer will find himself without the limited protection available from the bond once the date has passed.

Whilst contractors and sub-contractors continue to quote low, or no, prices for bonds in their tenders, then employers should continue to obtain bonds and an on-demand bond is to be preferred to a conditional performance bond due to the readily available access to the bonded sum.

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