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BONDS
Encouraging people to do what they said they would

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> *I may be allowed to remark that it is difficult to understand why businessmen persist in entering upon considerable obligations in old-fashioned forms of contract which do not adequately express the true transaction.*
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> Lord Atkin in *Trade Indemnity v Workington Harbour and Dock Board* [1937] A.C. 1 at 17

1. Introduction

The above quote, made by a very famous judge over 80 years ago, sadly remains apposite.

In that case, a bond had been issued, drafted in the traditional style favoured by lawyers since time immemorial; all one sentence, no punctuation, starting with "Now this deed …" and then littered with phrases and terms no one would use in everyday language; "of the first parts", "witnesseths", "hereuntobefores" and the like. Needless to say, His Lordship felt that if the intent could not reasonably be understood then the obligation could not be enforced.

In that case, the demand under the bond failed as party claiming could not establish loss as damages proved. More critically in this case, and in others since, much judicial time has been wasted considering whether a "surety" under a bond secures payment or performance, in which latter case the surety may be called upon to perform the contractual obligations itself.[1]

Turning to modern day New Zealand, we have a form of bond attached to the latest form of construction contract which one member of the drafting committee described as be "almost on-demand". Much like being pregnant, there is no halfway house. The difficulty with most bonds is that they are commonly used, they have a significant financial impact on the party who secures them, and yet they are rarely used for the purposes for which they are intended. They are simply required because they are attached to the standard form.

[1] This is a reasonably frequent arrangement in the US, where rather than simply providing a promise to pay, the surety may rectify the default itself by bringing in a new contractor or project manager. The amount secured by such guarantees are typically the entire contract price.

At their most general, bonds are nothing more than a promise by an unrelated third party to pay on the occurrence of an identified event. In that context, they can be very powerful instruments for encouraging parties to perform as promised, and to provide immediate compensation in the event of default; that immediate compensation can have the additional benefit of limiting project disruption and thereby also reducing any resulting claims for damages.

2. NZS3910

The Conditions of Contract for Building and Civil Engineering Construction, published by Standards New Zealand (NZS3910:2013) enjoys wide acceptance in the construction industry. However, it is almost never used without significant amendment by special conditions, whether to reflect the preferences of the client, recommendations from consultants, the particular needs of the project, or to play to the strengths, or to address the vulnerabilities, of the contractor.

The requirement to provide the contractor's bond is set out in clause 3.1 of the contract. Curiously, the clause deals with provision of the bond, its form, when it is to be released and when it may be called, but not the circumstances in which it may be called or the consequences of such a call.

The form of the bond, set out in in the schedules to NZS3910, is usually not immune to such tinkering. In standard form, the contractor's bond in Schedule 3 provides as follows:

(1) It is to be provided by both the contractor and "the surety"

(2) The recitals state, by way of background, that the purpose of the bond is to "ensure performance of the Contractor's obligations under the Contract."

(3) The contractor and surety are "jointly and severally" bound to the principal for an identified sum of money.

(4) The "conditions of [the] bond are that it shall be released" on the issue of the practical completion certificate; on the principal giving notice to the surety and contractor that the bond is released; and the principal notifying the surety that a replacement bond has been issued.

Again, while the bond talks about release, it critically does not deal with payment. Most banks will insist on including provision in performance bonds for the bank to pay out the amount secured by the bond at its option, notwithstanding that no demand has been made.

The bond goes on to state that its obligations are unaffected by any allowances, alterations or variations under the contract, thereby confirming that the bond creates independent obligations from those between principal and contractor under the head contract, though obviously they are related.

It also has to be acknowledged that while standard forms are useful, successful contracting involves a careful consideration of risk on a project by project basis and the adaptation of the form of contract to provide a sensible allocation of risk and responsibility. The trap many fall into is to simply follow the standard form because it is familiar, or in the mistaken belief that it reflects the way things are always done, or people know what it means, or simply because it is standard.

None of these justifications stand closer scrutiny.

Yes, tailored contracts need to be read and understood. It could as easily be said that a contract tailored to the needs of a particular project, and the parties engaged in it, has a better chance of working well than a business as usual approach.

So why then does NZS3910 propose bonds, when should they be used, in what form, for how much, issued by whom and when can they be called?

3. Purpose of bonds

Bonds have a long history in the construction industry.

In general terms, they are a promise by a third party to pay money in the event that one of the parties to the construction contract (typically the contractor, but not always) fails to perform. The bond is a stand alone promise to pay, independent of the contract itself; which can provide a useful incentive to perform (I shy away from saying they are used as a threat). This paper focuses primarily on the contractual mechanisms of bonds, rather than any commercial leverage they may provide. That is always a temptation; but that question relates more to the choice of contracting parties.

Strictly speaking, the contractor does not need to be a party to the bond, and has no part to play in it, other than procuring its bank or an insurance company to issue it to the client as a condition of being awarded the construction contract.

Usually, performance bonds are issued by banks or surety companies, and traditionally have secured a sum representing somewhere in the region of 10% of the contract price. In New Zealand, the tendency has been for the sum to reduce over the years to somewhere between 10 and 5%. This is also a symptom of the downside of following general rules rather than considering risk on a case by case basis. As with anything else, hard and fast rules tend to reflect a lack of engagement in any consideration of the actual risks of the project, and should therefore be avoided if possible.

There are a number of forms, the most common being either those which require proof of default (*conditional bonds*) or those which are more in the nature of a letter of credit (*on-demand bonds*). Each has a different purpose.

Conditional bonds

A conditional bond is generally viewed as being a guarantee of performance, rather than a pure promise to pay.

Where a conditional bond is issued, the holder of the bond may only make a demand on the bond issuer (referred to as *calling the bond*) once the condition identified in the bond has been met. In the construction industry, this usually means default by the contractor, asserted by the client, certified by the Engineer, or established by a final determination as part of the disputes process.

Typical wording for such a conditional bond would be "it is a condition of this bond that it shall be null and void if the contractor duly and properly performs its obligations under this contract".[2] In such a case, proof of default needs to be established first, and then the amount of loss arising from such default second.

[2] See *Richina Pacific Limited v AAI Limited (formerly Vero Insurance Limited) & Samson Corporation Limited* [2017] NZHC 1686 for a recent discussion of the effect of this form of bond. In that case, the contractor failed in the provision of a car stacker for an apartment building. The building owner incurred actual costs in rectifying the stacker, which costs were accepted by the court as being proven and recoverable. The issues under consideration were whether or not the bond was "on-demand" (it wasn't) and whether or not the bond had effectively been released by the issue of a Practical Completion Certificate for part only of the works (it hadn't).

In practical terms, unless the contractor acknowledges default and the amount of loss (which would be very unusual), a call on a conditional bond cannot be made until default and all losses have been proven.

In terms of NZS3910, this would mean that a *dispute* has arisen, the Engineer has reviewed the dispute, it has then been referred to mediation and the matter has then been determined by arbitration, with all the cost and delay associated with completing those processes, and any rights of appeal exhausted.[3]

For most projects, if the disputes process is to run its full course in this way, the wheels have usually fallen off the project as a whole. Most contractors and project managers have a desire (and an inherent faith in their abilities) to settle disputes as they arise, with a corresponding belief that formal disputes are to be avoided at all costs.

By the time the formal processes are invoked, the parties' positions tend to be entrenched, contractual processes frequently abandoned and losses and delays mounting. What may have started life as a dispute about ground conditions, will often have matured into a claim for damages, extensions of time and liquidated damages for delay.

Where liquidated damages for delay are often capped (frequently in the region of 10% of the contract price), it is not hard to see that conditional bonds generally do little more than provide a guarantee of the contractor's ability to meet a damages demand, often for little more than the liquidated damages. For major disputes, you would expect the proven losses following a breach of contract, and associated costs awarded in arbitration, to be well in excess of 10% of the contract price.

Conditional bonds are therefore of questionable value. If they cannot be called until losses are proven, then they should cover a sum which more accurately reflects the likely losses on a project at the time of demand. Conversely, if they can be called at the time of default, the losses are likely to be lower, and 10% may well be a useful sum to avoid the losses spiralling out of control.

There is a further twist on conditional bonds, and that is when they are offered as a *surety* to perform, rather than a simple promise to pay. In many cases,[4] the issue of whether or not the bond issuer is simply promising payment, or actually guaranteeing performance is a relevant issue.

On-demand bonds

An on-demand bond, by contrast, is nothing more than a promise to pay.

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3 For the sake of completeness, the leading case on this issue is the House of Lords decision in *Trafalgar House Construction (Regions) Ltd v General Surety and Guarantee Co Ltd* [1996] AC 199 HL. In that case, the contractor required a bond from a subcontractor in almost identical terms to the form of bond attached to NZS3910. The subcontractor went into receivership and failed to complete the subcontract work, and the head contractor called the bond. The receivers challenged the demand, arguing they should have the right to defend the amounts claimed before payment was made by the bond issuer. The House of Lords agreed, holding that the form of bond was in the nature of a *guarantee* and that any amount demanded was subject to proof, for which the contractor was entitled to raise all questions of sums due and cross-claims otherwise available in an action for damages. While the reasoning is impeccable, in practical terms, not much use to the contractor relying on such a bond.

4 See the *Trade Indemnity* case quoted at the head of this article for an example.

Typical wording for an on-demand would be "the bondsman undertakes to pay any amount up to [$] (in aggregate) demanded from time to time, without proof or conditions as to the default of amount of loss."

In practice, this means that the demand is made at the time of default, before any formal dispute process is commenced. It goes without saying that the demand is made directly to the bond issuer, and the contractor generally is not in a position to prevent the issuer of the bond from paying.[5]

In the recent unreported case of *Custom Street Hotels Limited v Plus Construction Ltd,*[6] the contractor procured the issue of an on-demand bond through its local bank in Auckland. While the bond was on-demand, the contract conditioned any demand by the owner requiring a certificate from the Engineer that there was default under the contract and the amount of the demand being "properly due under the contract." Both parties purported to terminate the contract, and the contractor took court action to restrain the owner from making demand. The question of the demand under the bond went to arbitration.

The arbitrator found, among other things, that *properly due under the contract* did not mean claimed, but proven as damages and on that basis the Engineer could not have certified as the contract required. On appeal, the High Court upheld the arbitrator' award; the matter is to be heard in the Court of Appeal next month.

While it has to be accepted that an on-demand bond is susceptible to abuse, that has not tended to be the case. Calling bonds is extremely rare,[7] and when a bond is called, it must not be overlooked that the client must eventually account to the contractor for all amounts demanded.[8]

For the bond issuer, the critical issue when receiving a demand is to be satisfied that the requirements for making demand have been met. That analysis can be carried out by reviewing the

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5 The leading case on *on-demand bonds* is the English Court of Appeal case of *Edward Owen v Barclays Bank* [1978] QB 159 CA. In that case, the bond was given by Barclays Bank to secure performance by an English company for the supply and erection of glasshouses in Libya; demand could be made *without proof or conditions*. The contract was completed successfully, following which the Libyan client called the bond. The contractor took injunctive action to prevent the bank from paying. Lord Denning held that, in the absence of fraud, "*these performance guarantees are virtually promissory notes payable on demand*". In the context of letters of credit and interbank bonds, this reasoning is beyond reproach. Lord Denning's assumption that the bond must have represented a discount is perhaps worthy of reconsideration. The bond demand must have been close to fraudulent in that case.

Conversely, in the case of *Simon Carves Ltd v Ensus UK Ltd* [2011] EWHC 657 (TCC), Mr Justice Akenhead granted an injunction to restrain the defendant from calling a performance bond on the basis that the claimant had established a strong case that the defendant was not entitled to call the bond under the underlying contract. The distinction between this case and the *Edward Owen* case is important. On the one hand (*Edward Owen*), banks cannot and should not be restrained from paying out on a demand under an on-demand bond (save in the case of fraud); whereas on the other hand (*Simon Carves*) the party intending to make a demand can be restrained if the demand is wrongful in terms of the underlying contract or the contract contains any preconditions which must be met before making demand.

6 [2016] NZHC 3049, per Gilbert J.

7 I have had only three occasions (in over 30 years of practice) where clients have instructed me to call bonds.

8 Contrast this to Lord Denning's curious *obiter* in the *Edward Owen* case cited in footnote 3 above, where he commented that such a bond must have represented a discount arrangement, which was to be called in any event on completion of the work. One suspects that this was news to the unfortunate contractor in that case.

bond and the demand on the face of those documents, without enquiring as to the underlying breach.[9]

An on-demand bond therefore has the benefit of providing a source of interim funding to cover the cost of dealing with a default (notwithstanding that the parties are in dispute) for a significantly lower amount secured, and at a lower overall cost (see comments below), than a conditional bond securing a similar default. In contrast to a conditional bond, the sum demanded under an on-demand bond is then used to cover the cost of removing the contractor, securing the site, rectifying any default and engaging a new contractor for the work. In that context, 10% or less is a more than adequate sum.

The protestations of contractor's to the contrary (and perhaps the drafting committee of NZS3910), it cannot realistically have been their intention to secure the outcome of an arbitration with only 10% of the contract price secured. That would be a paltry sum, in the scheme of things.

Why have bonds?

While there is a general benefit to requiring bonds, it has become the habit to require a bond as a matter of course simply because it is provided for in the contract.[10]

Bonds are expensive to procure, and rarely called. To my mind, not enough consideration goes into the requirement, and in most cases bonds can be dispensed with altogether, provided the contractor is adequately capitalised (a question which should be asked of any contractor, or client for that matter); adequate quality control measures are in place; timely payment follows satisfactory completion of each item of work; and title passes to the client as work progresses (regardless of payment).[11]

If the bond is to provide a sum of money at the time of default, on account of proven losses, then an on-demand form of bond, securing a reduced sum may well be appropriate. While 10% provides a useful starting point (corresponding roughly with the majority of the contractor's profit margin), each project should be considered on a case by case basis; what is required is a sum which is adequate to cover the cost of re-tendering the project and covering all the disruption that would entail.

4. Which bond?

NZS3910:2013 provides for three types of bond:

(a) Contractor's performance bond (Third Schedule)

(b) Principal's bond (Fourth Schedule)

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[9] This position was confirmed in the case of *AES-3C Martiza East EOOD v Credit Agricole Corporate and Investment Bank* [2011] EWHC 123 (TCC), in which Mr Justice Ramsay held that a demand for payment under an on-demand bond is payable, provided the demand is appropriately worded and is accompanied by any documents which the bond requires, without any obligation to make any enquiry as to liability under the underlying contract.

[10] Note that NZS3910 also has provision for a Principal's bond, which is rarely if ever used. This is a matter which contractor's need to exercise some care. In a difficult financial environment, asking clients how they intend to pay for the work is prudent, and seeking a bond in many circumstances would not be unreasonable. I am sure most contractors would welcome an on-demand bond in such circumstances.

[11] Retention of title clauses are generally ineffective if not registered as a *security interest* under the Personal Property Securities Act 1999.

(c) Contractor's bond in lieu of retentions (Fifth Schedule)

In each case, the Contractor (or in the case of the second form, the Principal) is a party to the bond, and it is a conditional bond.[12]

For the reasons set out above, there is little point in procuring such a bond unless all the losses and damages likely to be awarded in arbitration are covered. The accepted approach of a sum up to 10% will invariably be insufficient.

Once all the conditions required for calling the bond have been fulfilled (either the contractor has accepted liability or the disputes process has been exhausted), the client will make demand for the amount of the award. If the contractor has the financial resources to pay the amount of the award, then the bond is of no relevance. It is difficult to imagine a contractor incurring the consequences of a demand on the bond if they can pay the amount themselves. A demand on the bond is only an issue, therefore, if the contractor refuses or is unable to pay the amount of the award.

Retention bonds

Retentions are deductions made from progress payments, held by the Principal to cover the cost of rectifying defects. Typically half of the retentions are released on practical completion, and the balance on the expiry of the defects period, provided all outstanding work and rectification of defects is complete.

For all contracts entered into after 31 March 2017, any retentions held are subject to a statutory trust imposed by ss18A-18I of the Construction Contracts Act 2002. Compliance with the requirements of the Act are not without cost and complication.

For the client and for the contractor, the cashflow cost of retentions are factored into the contract price; for the head contractor, retentions are simply passed on to subcontractors at an increased cost in order to maintain cashflow. Neither comes without cost to the project, or to the industry as a whole. The provision of a bond in lieu of retentions has considerable advantages in avoiding the compliance cost of the statutory trust, it also relieves contractors of this cashflow cost (though it is also questionable whether this benefit is passed on to subcontractors in practice).

As with the other forms of bond, the retention bond attached to NZS3910 is also conditional, requiring proof of breach and loss before demand could be made under the bond. For all the reasons set out above, on that basis a retention bond in the standard form is poor value for money for the client.

To my mind, there is considerable benefit in extending the contractor's performance bond (in on-demand form) for the defects period, and allowing the contractor to provide substitute bond for a reduced amount on the issue of the practical completion certificate to cover the defects obligations.

In addition to the bonds provided for in NZS3910, bonds are also commonly provided for:

(1) *Advance payment* – for contracts where there is significant expenditure, for example in mobilisation works or the acquisition of expensive contractor's equipment like a tunnel boring

[12] In the case of *Richina Pacific Limited v Vero Insurance* referred to in fn2 above, Justice Hinton accepted as a general principle that bonds are presumed to be conditional unless there are clear words to the contrary – see *IIG Capital LLC v Van Der Merwe* [2008] EWCA Civ 542 and *Vossloh Aktiengesellschaft v Alpha Tains (UK) Ltd* [2010] EWHC 2443 (Ch).

machine, and that expenditure is not reflected in value in the permanent works or anything of value capable of ownership, provision may be made for payment of a lump sum shortly after award as an advance on progress payments.[13] The advance is secured by an on-demand bond for the full amount of the advance, released once the advance has been fully recovered.

(2) *Offshore manufacturing bond* – where significant items of equipment are manufactured offshore, the equipment supplier is unlikely to commence manufacture without payment of a substantial deposit and it will not ship the equipment to the site in NZ without the balance of the purchase price being paid (or most of it). In those circumstances, the contractor will often be required to provide a bond to secure the total of the offshore payments, such bond again to be on-demand and to be released only on delivery to the site in an undamaged condition.[14]

(3) *Technology risk/process risk guarantee* – for technology or process contracts, the risk of failure can be substantial. Historically, these would be the subject of *turnkey contracts* under which the contractor does not become entitled to payment until it establishes that the technology or process actually works. Financing the entire development and installation cost, and the scale of such projects, has made *turnkey contracts* of that form largely uneconomic. The alternative is to provide for progress payments secured by an increased performance bond; the contractor must then establish engineering completion (ie, proof that the process works) at which point the plant is taken over and liquidated damages cease; and performance testing, at which point the purchase price may be adjusted by performance related liquidated damages, based on measured output, efficiency and reliability. If the plant fails the commissioning tests within an acceptable measured performance level, the owner has the option to require the plant to be removed, the site returned to a greenfields condition and all moneys paid refunded. These obligations are supported by the bond.[15]

In each of these cases, the requirement for the bond, and the amount secured, is specific to the project risk. For many linear projects (laying pipe, constructing a road etc), provided there is a proximate match between the progress payments and the value of the permanent works, then the bond might secure only the cost of removing the contractor, rectifying any defective work and retendering the remainder.

For others, the potential cost of removing the contractor may be more.

5. Who provides the bond

Bonds are typically provided by either banks or by insurance companies.[16] Each charges a different cost and each treats bonds in different ways.

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[13] The FIDIC forms of contract provide for the option of advance payment of up to 10% of the contract price, secured by a bond and repaid by the deduction of 25% of progress payments after the first 10% has been certified for payment under the contract.

[14] Typically, there would be a delivery/acceptance inspection at which all over seas deliveries are examined to ensure there is no damage which may need to be claimed under a marine shipping policy within 28 days of delivery.

[15] See FIDIC Orange Book, Yellow Book and Silver Book.

[16] There are surety companies offering contractor's bonds, but the bonds are typically re-insured through large insurance companies, or discounted.

Banks

For banks, bonds (whether on-demand or conditional) are treated in the same way as any stand-by letter of credit or other loan facility; they are financial accommodations which must be secured by appropriate assets (cash in the bank or property covered by a mortgage or other security); contractors must also satisfy the banks that they can repay any amount demanded, plus interest charges, as with any other loan arrangement. Effectively, any amount demanded under a bond is treated as a drawdown of a secured loan, which incurs interest and requires repayment.[17]

Amounts secured by bonds are therefore included in all the contractor's other indebtedness (despite the fact that they are unlikely to be drawn) when its bank assesses the contractor as a security risk; they are therefore treated as being *on balance sheet*, having a direct impact on the contractor's working capital.[18]

In terms of cost, depending on how the financial strength of the contractor and the risk of the bond being called, banks will charge in the region of 2.5% of the amount secured as an establishment fee, and will then charge interest on any amounts demanded.

Insurance and surety company issuers

Conversely, insurance companies tend to treat bonds as contingent liabilities (like insurance contracts). Whereas a bank will pay out a demand under a bond without flinching (typically, regardless of whether it is on-demand or conditional), an insurance company will first assess whether or not it must pay; as it would with any insurance claim. Historically, as insurance companies tend to treat bonds as contingent risks, the security position is also different. The requirements for security for payment tend to be *off balance sheet*, which has the potential to provide considerable relief to the contractor's working capital requirements.

As a consequence, insurance companies and sureties charge more for the provision of such bonds. Depending on how they assess the risk and the quality of the contractor, insurance companies will charge anything up to 5% of the amount secured, usually with an annual fee.

Insurance companies and sureties also tend to be extremely reluctant to provide bonds in on-demand form.

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[17] From drafting perspective, banks will typically have three requirements in the bonds – (1) the benefit of the bond cannot be transferred (this is usually not a problem), (2) the banks must have the option to pay down the bond at any time, whether or not any demand has been made (it is unusual for this to be an issue), and (3) many banks require an expiry date (this is a problem, and should be resisted – while the underlying facility agreement between the contractor and the bank may be finite, few projects can be assured of finishing on a given date. Requiring the client to carry the risk of the contractor's funding renewal is unreasonable, and this requirement should not be accepted. Some banks will quote ICC interbank letter of credit requirements – these are, strictly, not relevant. Provided the bond expressly expires on practical completion, or certification of defects, that should be sufficient).

[18] It sometimes happens that a contractor will announce that there bank will not issue the bond in the required form. It is helpful to remind banks that they have issued similar bonds for other clients, or to advise that the client's bank will issue the bond for them, provided sufficient interbank bonds are provided to support the bond. Deadlocks in negotiation will usually miraculously disappear at this point.

One of the biggest issues with the New Zealand construction industry has been the capitalisation of its construction contractors (or lack of it).[19]

In my experience, when a contractor demurs over providing an on-demand bond from their bankers, it is often an indication of a deeper malaise within that company. It rather begs the question as to why the contractor is prepared to pay an insurance company more than their bank would charge for a bond in the same form.

6. Conclusion

As with any contractual mechanism, bonds should be considered as part of the overall security position, on a project by project basis.

The first issue is to consider the relative project management competence and expertise of the client, and its appetite for risk; the second is to consider the risks inherent in the project, and to agree a sensible allocation of risk and adapt the contract accordingly; and the third is to review the relative strengths the contractor will bring to the project, and its potential vulnerabilities.

It is only after reviewing those issues that sensible decisions can be made about how performance is to be secured, and what mechanisms are available to deal with the potential for default. Both parties have a vested interest in the successful completion of the project, even when things get difficult.

Bonds form only part of the overall security available. Whether or not a bond is required, and in what form and from whom, will vary from project to project, and it has to be remembered that they do not come free. The critical issue is whether or not they provide value for money for the party claiming the benefit of the bond.

Generally, a bond dependent on proof of default, securing a relatively modest sum (like 10% of the contract price), will be of limited value, and will hardly justify its cost. Conversely, a truly on-demand bond securing the likely cost of disruption to the project, caused by a contractor which has lost interest in the project, can be very useful indeed.

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[19] The recent tribulations of The Fletcher Construction Company Ltd are a case in point.