Performance Bonds – The Pearls and Pitfalls

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Introduction

- Performance bonds and purpose in construction
- On demand/conditional bond
- Making calls – preparation and practicalities
- The UAE approach – reactions to calls
- UAE local law and court process: attachment orders and challenges
- UK approach – *Doosan Babcock*
- Key ways of avoiding/resolving bond issues
What is a Performance Bond?

- **Performance Bond** - a legal instrument to guarantee due performance of a project
  - contractual undertaking
  - by a financial institution (typically a bank or insurer - also described as surety/guarantor)
  - to pay a specified amount
  - to a named employer

This might be triggered on occurrence of a certain event (ie breach of contractual obligation by contractor) or by a simple demand to the bank in the absence of any event.
Performance Bonds - Purpose in Construction

- Employer - Assurance of performance
- Intention is payment in the event of default (can be abused)
- Usually underlying construction contract between employer and contractor establishes the bond
- Call is between the employer and the bank, but significant repercussions for contractor (see later)
- Bank separate indemnification with contractor
On Demand Bonds

- What is an ‘on demand’ bond?
  - True ‘on demand’ – no proof of any breach/default in the underlying contract or damage to the employer
  - Mere demand will trigger liability, **EVEN** if there is doubt as to whether a contractual obligation has been breached
  - Bank is obliged to pay provided demand is presented in accordance with the terms of the bond.
  - Not made conditional by requiring certain formalities (ie in writing/addressed to named person etc)

- Example on demand bond

  "At the request of [the Contractor], we X Bank irrevocably and unconditionally undertake to pay you on your first written demand and waiving all rights of objection and defence and without reference to the contractor an amount or amounts not exceeding in aggregate UAE Dirhams 99,000,000.""
On Demand (Continued)

- Significant risk of abuse – Know who you are contracting with!

- Impact of call on contractor
  - Risk of irreparable damage to reputation with bank (even if wrongful call – bank may not issue other bonds)
  - Financial concerns - credit is tied up = limited cash flow (progress on project may be affected)
  - Contractor may not qualify for tenders, as may need to disclose calls on bonds
Conditional Bonds

- Conditional bond is a written form of guarantee – effect is to guarantee payment of loss once established.

- Liability of bank is conditional on proof of a breach of the underlying contract and loss.

- In construction conditional bonds are contractor’s choice – limits risk of improper calls.

- Less attractive to banks as they can be drawn into contractual disputes.

- Example of a conditional bond:

  "If the Contractor fails to pay any sum that becomes due from it to the Employer under or in connection with the Contract (including any debt, damages, interest or costs), the Employer may give notice to the Surety requiring the Surety to pay that sum, up to the Maximum Amount, to the Employer."
Key Differences Between On Demand/Conditional

- Conditional require proof of breach of underlying contract – on demand, no proof

- If conditional a bank can rely on all defences available, including set off, of the contracting party’s performance he is guaranteeing

- On demand bond, no defences are available regardless of default

- Note about ‘indulgence provision’
  - Commonly seen in bonds to avoid the bank/surety escaping liability
  - “no alteration or variation to the contract terms shall in any way release the surety from liability”
  - Insolvency issue – not of itself a breach of contract, make it a default in the contract or expressly refer to it in indulgence provision in the bond
Example Bond Wording

Question:

Is the below conditional or on demand?

“We MoneyPenny Bank, hereby irrevocably and unconditionally guarantee and undertake to the Employer, without any right of defence, set-off or counterclaim whether on our behalf or on behalf of the Contractor to pay the employer the sum of not less than UAE Dirhams 99,000,000 upon receipt of the Employer’s written request addressed to us in the event that the subcontractor fails to perform or fulfil any of its obligations set forth in the Agreement…”
Multiple Choice

■ A) Conditional
■ B) On demand
■ C) Either

■ Answer C
Making the Call – Preparation and Practicalities

- Look at the wording and the context of the Bond!!
  - Is it truly ‘on demand’ or is it conditional

- Uncertain
  - Get legal advice on bond wording before pressing ahead with call
  - In the UAE, the Arabic reading of an English worded bond, may provide a different interpretation, so what you think may be on demand may be quite different in Arabic
  - Speak to your own bank – how do they view the bond?
  - Belt & braces approach provide supporting evidence, but ask your bank what support they would expect to see.

- Check the contract - ie steps prior to calling the bond?

- Formalities in the bond - easy to fall foul!

- Aim - leave no room for challenge/escape of liability by Bank
UAE - Reactions to Calls: The Contractor

- The call is coming
  - Awareness of possible call: write to bank,
  - Prepare for attachment (freezing of monies)

- No knowledge
  - Usual for bank to inform contractor upon receiving call
  - Depending on relationship the banks may create a delay to making payment, this is particularly so if wording of bond is unclear – can provide time to apply for attachment
UAE - Reactions to Calls: Bank and Obligation to Pay

- Banks must pay if on demand - it does not matter if calling is considered unfair, there is no default in performance

- No clear provision about timing for payment, but in our experience it can be immediately (2 days usual) or even up to 2 weeks (unusual).

- Justification for bank not paying out – attachment order freezing the bond monies

- **BUT**, unclear wording - banks may use this to delay in paying out to “investigate”.

- Repercussions if bank fails/delays payment?
  - Attachment – likely to be able to hide behind it.
  - No attachment – file a claim
UAE Attachment Orders

- Criteria
  - The bond has been called
  - Pre-emptive - very rare

- Article 252 of Civil Procedure Code - key elements flight risk/financial instability

- Clear evidence to demonstrate why attachment should be issued – usual arguments:
  - Taking Over Certificates / Completion Certificates
  - Certified unpaid sums showing monies due to contractor.
  - Call is fraudulent

- Application should be simple and only necessary supporting documents to be provided
  - Court does not look at merits
  - Treated as an urgent matter: more paper = potential delay
UAE - Court Process

- Ex Parte (without notice) application in summary court
  - *If Unsuccessful* - employer not aware
  - No reasons are required
  - No res judicata, so can reapply
  - If successful after reapplying, reasons must be given by court as to why decided differently

- *If Successful* - notify bank and bond amount frozen

- Within 8 days of service of attachment must file substantive (merits) case.

- Substantive case can be in court or arbitration.

- Attachment will remain in place until conclusion of substantive case or overturned prior to that by successful objection
UAE - Can you Challenge an Attachment Order?

- Employer right to file an ‘objection’/ ‘grievance’ to attachment order

- Dealt with by summary/urgent court

- Arguments that may lead to overturning the attachment:
  - Due to procedural failing of court (ie reasons).
  - Bond clearly ‘on demand’
  - Contractor refused to extend the bond in accordance with contract

- Overturning does not prevent contractor from re-applying for an attachment, but would need to be based on different facts
UK Law Approach

- Doosan Babcock Case – Injunction granted for an ‘on demand’ bond…
  - Doosan Babcock agreed to supply two boilers to a power plant in Brazil, owned by MABE.
  - Doosan issued two “on demand” performance bonds with respect to the boilers.
  - Bonds to expire:
    - on 31 December 2013 or
    - on issue of Taking-Over Certificate (TOC)

- In this case, Court found that Doosan had a good arguable case (without finally deciding the issues - that was for arbitrators) that:
  - TOC might be due
  - MABE refusal to issue TOC = wrongful attempt to keep bonds live
  - MABE should not profit from own wrongdoing.
UK Law Approach Cont’d

- Similarities between UK/UAE law approach?
  - English Courts can intervene, under Arbitration Act, to assist matter otherwise subject to arbitration.
  - Previously, conventional wisdom that a call of an “on demand” bond difficult to stop, save in cases of fraud/obvious wrongdoing.
Key Ways to Avoid/Resolve Bond Issues

- Clear wording – on demand/conditional needs to be carefully considered at drafting stage

- Agree form of bond at pre-contractual stage: Contractor prefer conditional/ Employer will prefer ‘on demand’

- Check contract obligations – requirement to extend (contractor) / failure to comply may lead to unsuccessful call (employer)

- Check all bond formalities met

- Get legal advice before taking action - make sure ready to press the button whether making the call or applying for an attachment/injunction
Questions?

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