

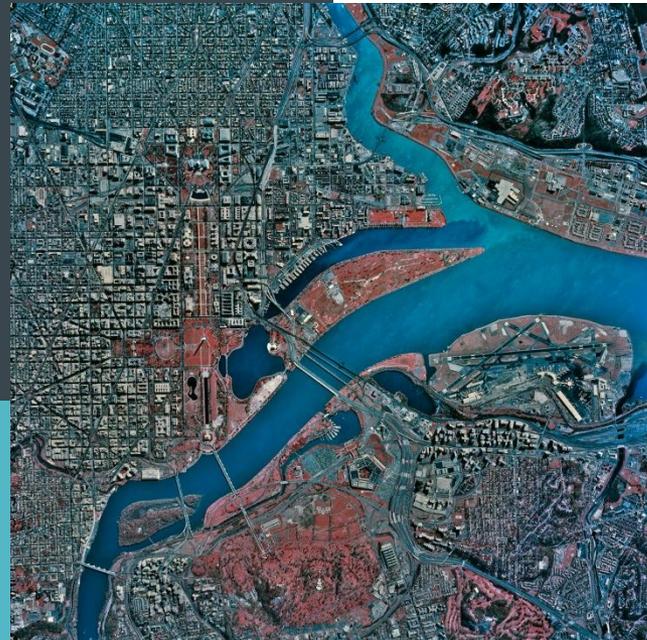
Breakfast seminar

Performance Bonds and Parent Company Guarantees

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Outline

Introduction / Recap

Market Conditions – post Carillion

Performance securities – why is it important?

Performance Bonds

Parent Company Guarantees

Case Study

Questions?

Recap of previous briefing

- Employers, suppliers and funders should take active steps to guard against the risks of potential insolvency of contractors by:
 - prioritising correct types and levels of insurance – deductibles should be checked in particular.
 - triggering rights against insurers under the Third Parties (Rights against Insurers) Act 2010 quickly.
 - ensuring they have the correct documentation in place, with clauses to mitigate the fallout of insolvency.

- Today's briefing will focus on contractual documentation in the form of third party performance securities: Parent Company Guarantees (PCGs) and Performance Bonds and the implications of market conditions post-Carillion for such arrangements.

Market condition – post Carillion

- Carillion's JVs – the other joint venture party remained responsible at the time of Carillion's insolvency:
 - Balfour Beatty – initially estimated around additional £45m required – its liabilities had risen by a further £23m on the Aberdeen Western Peripheral Route project and were forecast to reach £135m.
 - Galliford Try – sought to raise around £150m and cut its dividend to support its balance sheet claiming Carillion's collapse had “increased the group's total cash commitments on the project by in excess of £150m”

- Impact on the market
 - Reduced lending activities:
 - Peer-to-peer property lending platform saw unexpected 4% fall in lending to the commercial property sector in January 2018
 - Subcontractors are facing insolvencies:
 - Sammon Construction: £7m owed by Carillion
 - Vaughan Engineering: £650,000 owed by Carillion

- Highways England confirmed that it did not hold any construction surety bonds with Carillion companies – any PCGs held will have become valueless

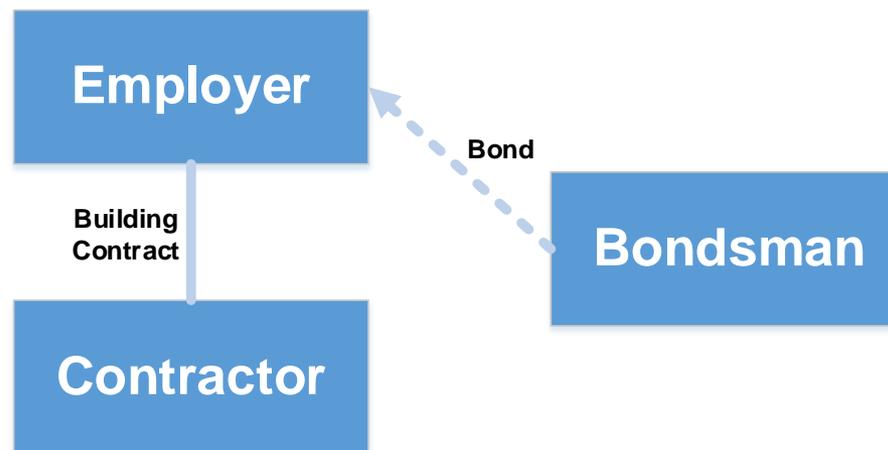
- Carillion short sellers now targeting Kier

Performance Securities – why is it important?

- Purpose: security for losses sustained by the developer should the contractor fail to perform its obligations under the construction contract
- JCT standard form: Section 7, Clause 7.3 –
“the Contractor to provide... substantially in the form of the document identified by the Contract Particulars”
- Key issues to consider in relation to securities:
 - Bankability
 - Funder’s requirements
 - Incentivises due performance
 - Covenant strength of the contractors and the parents
 - Primary obligation vs. Secondary obligation

Performance Bonds

- Types of Performance Bonds:
 - On demand
 - Conditional/default
- Typically 10% of the contract price
- Key considerations: Costs, duration, credit rating of the bondsman, jurisdiction of the bondsman, clear wording of the bonds



Performance Bond – Some issues to consider (1)

■ Enforceability

- Hudson’s Building and Engineering Contracts 13th Ed – “It may be possible...to use the adjudication decision as proof of default...On the other hand, the temporary binding nature of the adjudication decision may provide a defence to the guarantor. It is submitted that ***the answer may depend on the particular words of the instrument of guarantee and any underlying building contract***”
- Re Kitchen: not enough that the employer has obtained an adjudicator’s award, judgment or arbitral award against the contractor for the guarantor to pay out
- Beck Interiors Ltd v Russo: “a party might neglect to defend itself properly; might make admissions or might otherwise conduct the case in the dispute resolution differently from the guarantor. Therefore, to overcome that difficulty, ***what is required is an agreement by the guarantor to be bound by the decision of an adjudicator, arbitrator or the court as between the parties*** to the contract or other means under which underlying dispute arises”

Performance Bond – Some issues to consider (2)

■ Guarantee Bond vs On demand bond

Trafalgar House Construction (Regions) Ltd v General Surety & Guarantee Co Ltd [1995]:
House of Lords reconfirmed the distinction between a guarantee and an on demand payment obligation and clarified that the two type of bonds are not to be treated in the same way.

**WHY IS THE DISTINCTION
IMPORTANT?**



On demand bond

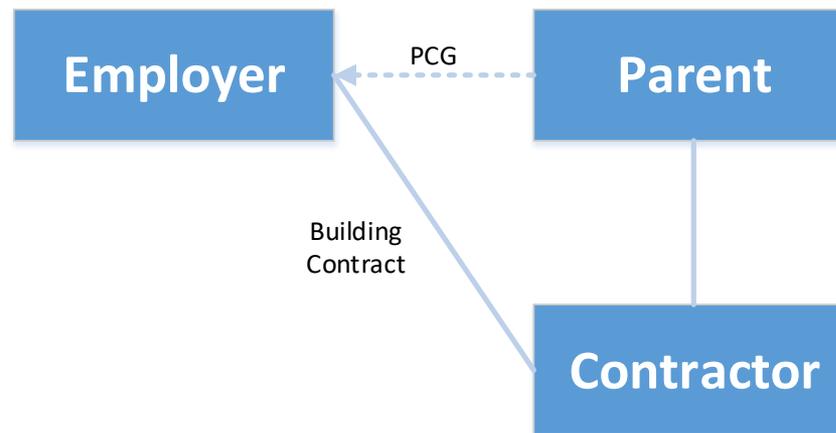
- Primary obligation – separate and independent of the Contractor and could still survive the termination or invalidity of the underlying contract
- the Contractor has no defence against a call on such a bond other than fraud and, generally, there can be no effective challenge to the Employer's demand
- Who may favour a primary obligation?
 - Beneficiaries: immediate source of cash (no need to prove that there has been a breach of contract); bond/indemnity remains unaffected if there has been a change to the underlying document
 - Bondsman: avoid being involved in disputes

Guarantee Bond (usually based on ABI standard form)

- Secondary obligation – bondsman has the right to put the beneficiary to proof of breach of contract and loss and is also liable to the same extent as the Contractor, subject to the overall limit imposed by the bond amount
- In principle, the bondsman can rely on all rights, counterclaims and defences available to the Contractor – as the bondsman's liability is co-extensive with that of the Contractor, the guarantee bond must be considered in conjunction with the bonded contract
- Who may favour a secondary obligation?
 - Contractor: able to try and reach an agreement before Employer enforces its rights

Parent Company Guarantee

- Parent Company Guarantee is commonly on default – i.e. guaranteeing the liability of the contractor
- Guarantor usually relies on the same defence and limitations of liability provided under the underlying contract.



PCG - Some issues to consider (1)

- Some PCGs contain an **indemnity** along the lines of the following:
 - *“As a separate and independent obligation, the Guarantor unconditionally and irrevocably indemnifies the Employer immediately on demand against any and all losses, damages, expenses, liabilities, claims, costs or proceedings which the Employer may suffer or incur by reason of any default or failure on the part of the Contractor to perform fully or promptly any of its obligations under the Contract”*
- A guarantee is a secondary obligation and depends on underlying contract. If the underlying contract is set aside – the guarantee falls away. Variation of the contract may discharge a guarantor’s liability.
- An indemnity is a separate, primary obligation and could survive the termination or invalidity of the underlying contract. Similarly, the variation of a contract will not discharge the liability of the party giving the indemnity.
- The inclusion of an indemnity provides the employer with an additional level of protection.

PCG - Some issues to consider (2)

■ Amendments to or invalidity of the underlying contract

- Invalidation of the building contract, or variation to the contract without the guarantor's consent, can affect, or even discharge, a guarantee.
- PCGs often contain provisions under which parties agree that certain scenarios, including variations to the contract that could otherwise affect the guarantee, will not '*reduce, discharge, impair or otherwise affect the obligations*' of the party giving the guarantee ('indulgence clause').
- Pitfalls remain:
 - *Triodos Bank NV v Dobbs [2005]*: if the variation of the underlying contract makes the guarantee more onerous or increases the liability of the party giving the guarantee, the consent of that party should be obtained. One must ask whether the new obligations in the contract are so different to the original obligations that they cannot be properly described as amendments or variations.
 - *Hackney Empire Ltd v Aviva Insurance UK Ltd [2012]*: (the Alan Sugar case) where there has been a variation to the contract, and the guarantee contains language to the effect that it will not be invalidated by a variation, the party giving the guarantee will only be liable to pay '**if the contract remains within the general purview of the original guarantee**'.
 - *Maxted v Investec Bank Plc [2017]*: whether variation/amendment will affect the guarantee where the parties have agreed to an indulgence clause depends on factors such as the language of the clause, the experience of the parties and their intention.

PCG - Some issues to consider (3)

■ Execution

- Guarantees (and indemnities) are often executed as deeds. This avoids any argument about whether consideration (i.e. something of value) has been provided to the party making a contractual promise (here the party giving the guarantee). Unlike normal contracts, deeds do not need to be supported by consideration to be enforceable, nor does there need to be a clear process of 'offer and acceptance'. Deeds also benefit from longer limitation periods than normal contracts (12 years > 6 years).
- Deeds have specific execution formalities, which must be complied with for the document to take effect as a deed. These are as follows:
 - a deed must be in writing;
 - it must clear on the face of the document that it is intended to be a deed;
 - the deed must be duly executed (for a company, a deed will normally be executed by two directors, or by one director in the presence of witness who attests the signature); and
 - the deed must be 'delivered' to be effective. Previously, delivery meant physical delivery. Nowadays delivery means any act which signifies the intention of the parties to be bound.
- If a deed has not been properly executed, it can sometimes take effect as a simple contract. However, a guarantee executed as a simple contract may not be enforceable if good consideration has not been provided to the party giving the guarantee, or if there has been no clear 'offer and acceptance'.

Factors to consider – which one is more appropriate?

Reasons for choosing Performance Bonds

- No parent company
- Identity of the parent company/enforcement concerns
- Covenant strength of the parent
- High exposure to the parent company (e.g. number of projects)
- Capacity to give guarantee (e.g. constitutional documents)
- Survives group insolvency
- Can be “on demand”

Reasons for choosing PCGs

- High cost of the bond (premium)
- Commitment to the project (prevents parent walking away)
- Duration of the guarantee is typically as long as the contractor’s liability
- No explicit financial cap - usually guarantees full liability (as opposed to the bond which typically covers 10% of the contract price)
- Often guarantees due performance of the contractor

You can ask for both

Case study – Negotiating the Performance Bond

- Owner of the building looking to develop the site that they have acquired. Owner engaged a development manager (the “Employer”) to develop the building.
- As part of the performance securities, the Owner wanted to put in place a performance bond.
- Main concerns
 - Uneasiness around the stability of the market given Carillion insolvency
 - Ability to step-in and fix the problem early
 - Quick payment if problem arises
- Key features
 - Joint beneficiary (both to the Owner and the Employer)
 - Expiry of the performance bond

Case study – Enforcement Issues

■ Background:

- A contractor (the “Contractor”) was engaged by a fund (the “Employer”) for the design and construction of a large project. Various disputes arose on a series of adjudications and arbitrations in relation to contract formation, negligent design, defaults, delays and termination claims and counterclaims.

■ Legal and practical issues:

- The Employer obtained a PCG from the Contractor’s parent (“the Parent”) and a Guarantee Bond based on the ABI model form (i.e. not an ‘on-demand’ bond).
- The Parent argued that the guarantee element of the PCG fell away due to invalidity of building contract and/or adverse variations to the building contract without the Parent’s consent. However, a separate and independent indemnity was included in the PCG. The Parent was a foreign company and the PCG was executed as a deed with the normal formalities required.
- The Guarantee Bond was a secondary obligation as opposed to an On-Demand Bond. So, the invalidity of, and significant adverse variations to, the bonded contract could have affected its enforceability.
- Notification provisions under PCG must be looked at: there could be clauses which require prior notification of the parent company or clauses requiring the parent company to be named as a party in formal proceedings so that any decision is “conclusive evidence” for the purposes of the PCG.
- Notification of disputes to the surety, especially regarding secondary obligations, in order to prevent the bond being called and to ensure that the surety is on notice that it could be drawn into a dispute.

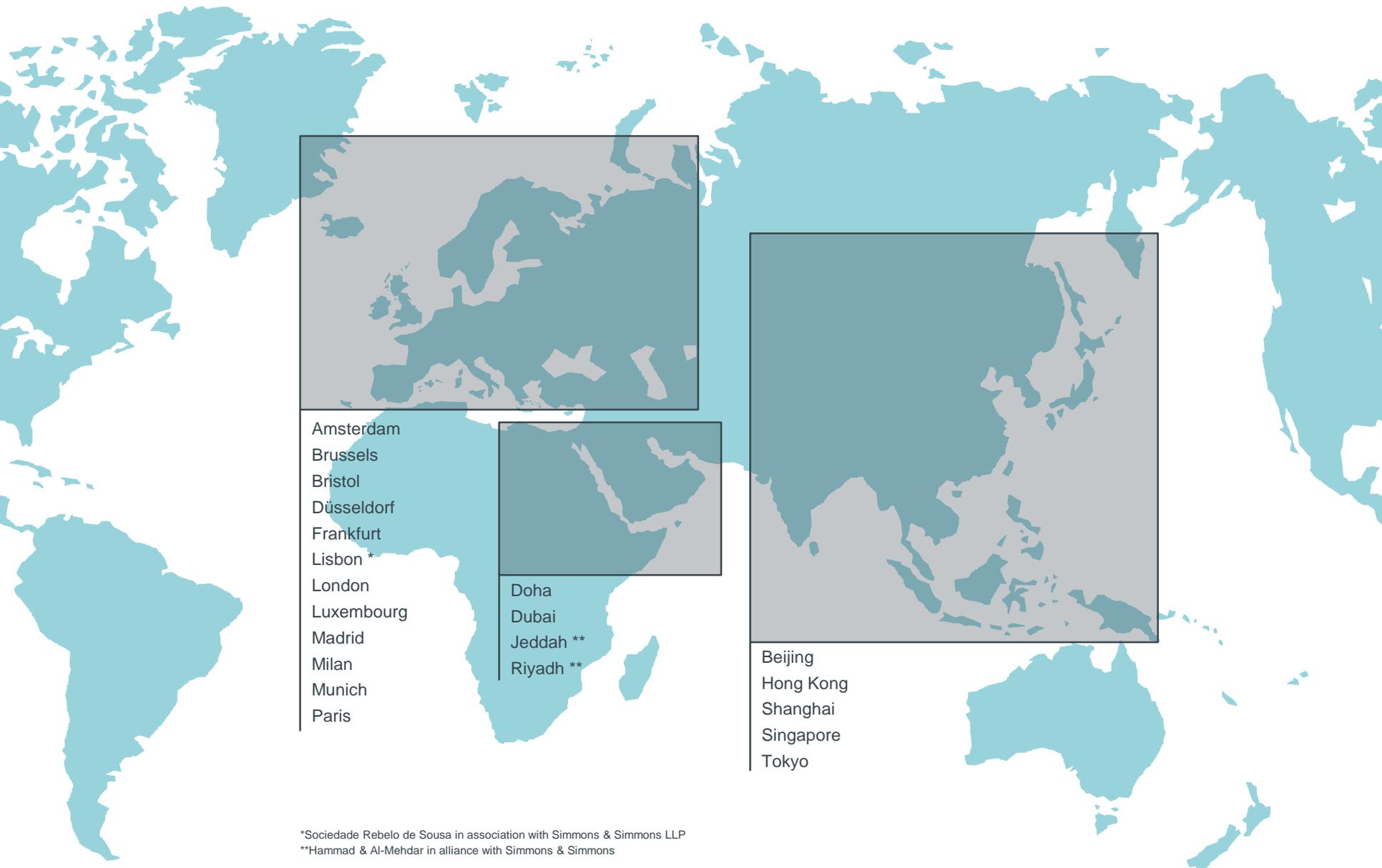
Question: Which of the following is sufficiently certain/final for an employer to enforce a Guarantee Bond: a) decision by the Court b) the decision of an adjudicator or c) the decision of an arbitrator?

Scenarios: multiple choice answers

1. A Limited is an owner of a site in the UK. A Limited is looking to enter into a building contract with B Limited. B Limited has a parent company, C Limited, but there has been concerns in the market that C Limited has a number of projects facing delays and there are rumours that C Limited is facing cash flow issues.
 - Parent Company Guarantee
 - Conditional Bond provided by the bondsman which is a sister company of B Limited
 - Conditional Bond provided by an independent bondsman

2. *“The Bank undertakes to the client that in the event of a breach of the Building Contract by the Contractor, the Bank shall discharge the damages sustained by the client as established and ascertained pursuant to and in accordance with the Building Contract.”*
 - On-demand bond?
 - Guarantee bond?

Questions?



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