The problems and abuse of performance bond in the construction Industry

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Abstract. Performance bond is a bank-origin system adopted in the construction industry to act as a tool to ensure project delivery. The bond is taken up by an obliging party with endorsement by a third party; normally a banking institution, which would warrants the release of an insured amount should the obliging party fails to complete the contracted work on time or as agreed. The nature of the instrument is said to be perplexed and abusive. The research aims to investigate this claim. Applied legal research using both doctrinal and non-doctrinal legal research is employed. With the application of deductive reasoning, the data is processed and summarized. It is found that the term bond and guarantee, which are used intermittently but equivocally by the parties, should be distinguished accordingly to its obligation values, or otherwise would trigger major disputes. Interpretation, drafting and liabilities issues caused by archaic language and dated recycled wordings in the contracts contributed nothing to the convenience and application of this instrument. The loopholes in the contract made it easy for suspected fraudulent calls to be made by the beneficiary, whom are normally, the client. With several trusted professional bodies discouraged the use of this instrument, the legal system is compelled to provide direction to ensure continuous utilization of this project delivery assurance mechanism. Standardized system and structure is vital in order to obtain uniformity in its application.

1. Introduction

Completion of a contracted work is of pinnacle importance in any construction contract and employers' compromises against them are deemed conditional. Contractors are expected to plan for contingencies if encountered with anything preventing them from delivering the contracted work. A structured back-up plan needed to be contemplated. Thus, the concept of performance bond, guarantee and any insurance-like scheme has been adapted into the construction contract as a financial mechanism to ensure project delivery.

As the owner demand assurance for the completion of a project, this bank-origin system was initially adopted to ensure that the completion is guaranteed without any extra expenses to the owner [1]. However, researches revealed that problems and plausible abuse of this subsidiary tool exist. In the UK, few owners as the beneficiary are drawn to the idea of obtaining the sum through false calls.

1.1 Aim and Objectives

The aim of this paper is to examine the complication and plausible abuse in the application of performance bond in the construction industry. The paper seeks to unravel the components and key principles in its application from the law perspectives and obtain potential improvement. The objectives are as follows:

- To untangle the ambiguities within the related terminologies and their consistencies in the usage
- To observe professional attitudes towards the usage instrument
- To investigate the law governing the implementation of the instrument
- To examine potential solutions and preventive steps to be taken to ensure impartiality in its implementation

1.2 Problem Statement

Performance bond are observed to be 'archaic and are frequently expressed in outmoded language and create obligations whose legal interpretation may be unclear' [2]. Terms such as 'on-demand' and 'unconditional' in performance bonds are deemed to be susceptible to various abuse [3] and unfair from the perspective of the contractors. The proneness of abusive calls has led FIDIC, ICC and IBA to take the initiative of reducing the risk by proposing the introduction to the term 'performance security'.

Professional approaches towards performance bond and law governing the implementation are alarming. There are multiple views observed in the policies, the court and international professional bodies towards the practice. This mainly involves the usage of term and interpretations used by each party from various disciplines. The issue of overpayment and fraudulent or unreasonable calls (illegitimate calls made not out of genuine cause) also requires investigations.

2. Literature Review

Performance bond is an promissory for the contractor's (the obliging party) to delivery the contracted works to the employer (the offering party) through an endorsement by a third party (normally financial institution or insurer) on the contractor's capability of carrying them out. As an assurance should contractors fail to deliver completion, the owner relies on the financial capacity of the third party to provide compensation [4]. Performance bond is viewed commonly as a contract between *the contractor* (the obliging party, or called *principal* in the bond) and *the third party* (a guarantor, bondsman or *surety*), which is signed and will be void if the related contract is carried out as agreed but shall warrant a release in favour to *the owner* (the offering party, or *beneficiary*) if the contractor fails to meet the conditions.

As revealed in law cases, the courts differentiated bonds and guarantee as different subjects, while some members of the industry understand them as similar means, with very few and limited exceptions [5]. However, there are fundamental distinctions between the on-demand performance bond which contain a certain condition or *guarantee,* and the completely rigid and unconditional on-demand bond or *bond*. Thus, the thin line of distinction in terms should be measured according to their degree of obligations and never be underestimated [5].

It is pertinent that the term bond and guarantee are distinguished by comparing the weightage of the obligations, which can also be observed by classifying them into two types of obligation; primary obligation and secondary obligation. The general use of the term 'performance bond' in reference to all types is confusing, as the terms can be mistakenly used to refer both types of obligation [6]. Bankers would commonly describe them as primary obligation, while contractors understand them to be of secondary obligations. Thomas (2009) in *Dictionary of Banking Terms* deduced each term as follows:

> **Guarantee** – *three-party agreements; including a promise by one party (guarantor) to fulfil the obligation of a person owing a debt, if that person fails to perform.*
>
> **Bond/Performance Bond** – *bond that calls for specific monetary payment to a beneficiary if the purchaser or maker fails to do something or acts in violation of a contract. It may be a*

'surety bond' purchase from an insurance company or cash held in an escrow account by a bank or a third party.

In summary, the term bond and guarantee can be distinguished by their amount of obligation values, the parties bound by the contract and the outcome whenever the principal contract terms are dishonoured. Whilst primary obligation refers to the contract between the insurer (or surety) and the employer, the secondary obligation is a genuine tripartite contract. A guarantee is a promissory of the obliging party to fulfil the duties in the principal contract, in which failure would amount to the release of the bond. Only a primary obligation contracts could trigger an on-demand calls under whatever circumstances as agreed in the contract. Therefore, most performance bonds should be characterized as the secondary obligations contracts. The trigger for release includes non-performance, failure to honour obligations under the contract and any eventualities that could amount to breach of contract terms.

2.1 Rights of Parties

Contractors as the obliging party would naturally favour guarantees over bonds, as guarantees provide more security and leniency in conditions of the contracts. The employers prefer the more autonomous bonds. The bonds are made easy for the beneficiary, or employer as demands can be called without being required to adduce proof of substantive default [7] and as effortless even via a simple phone call. [7] further expressed that on-demand bond exerts commercial pressure but contractors still reluctantly submits in order to compete; making it susceptible and abusive from the contractors' point of view.

Rules were provided to demand the employer to comply with procedures on calling for the bond, but were ignored [8]. The bank or insurance company has the prime obligation to honour the terms of the bond [8] on demand as long as all the requirements were satisfied [1]. Processing the call and claims are straightforward as it is not obligatory for them to question whether the call is bona fide or not. Hence, FIDIC discretion against the use of on-demand bonds due to their one-sided and confrontational nature [9] despite the sureties' preference towards bond contracts over guarantees.

2.2 Problems and Abuse

The ambiguity observed in the documents and the terms revealed confusion in deciphering whether the said instrument refers to the tripartite guarantee with lenient conditions *or* the autonomous unconditional and rigid on-demand bond. These confusion and potential trigger to dispute are caused by the lack of sufficient understanding of the exact nature of these instruments and the use of medieval language in their wording, compounded further by a miscellany of confusing terminology used virtually interchangeably [10]. The courts in the US and Canada had also criticized the practice, where it was discovered that many of the banking institutions and insurance companies continuously drafting contracts and bonds in a form that is archaic, obscure and full of traps for the uninitiated [11]. It was also observed that there are lacks in uniformity in the drafting process that led to difficulties in implementing the instrument and complication in monitoring the use of these tools. It is observed that the way the guarantee/bond documents are drafted to mainly benefit the employer. Sir Michael Latham urged the use of modern language with clear obligations and end date in guarantee/bond contracts to allow the beneficiary to claim without the need for litigation and this should be enforceable on default rather than demand [6]. Consequently, a clear, unambiguous and rigorous draft for guarantee *or* bond [7] is highly crucial.

[7] revealed that a bond could be easily called without the need to refer the claim through litigation or arbitration. It is also agreed that the bonds act as protection from non-completion where insolvency may be regarded as one of the factor. [12] revealed that the contractor's financial failure is the major cause for a bond to be called for. However, as discovered through law cases, insolvency alone is not the trigger for the release of a bond. It has become a thinly disguised solvency guarantee and a strong weapon in the employer's hands to ensure prompt completion [13].

3. Methodology

The suitability of doctrinal legal research and non-doctrinal research conducted for this research is due to the applied legal research nature [14]. Legal doctrinal research uses principles and law collected from known basic principles and established case law as basis of research. It is a study on the related law and its impact on a particular community; in this case the construction community. Relevant cases law related to performance bond were collected and examined to demonstrate the operation and efficacy of a particular law [15]. Therefore, all relevant cases enlisted are defined, categorized and analysed. To analyse the data, deductive reasoning is used. These include defining the principle, identifying a factual event and lastly, making a relation between the two to determine whether the principle applies or otherwise [14]. Governing rules from forms of contract and procedures supplied by the financial institution provide a basis and reference of comparison. Non-doctrinal research will focus on the application and study about the law. Inductive reasoning was also applied to identify whether a general accepted principles within a specific current event are complied or otherwise. Data were collected and sorted before a general content analysis was carried out. Finally, a comparative analysis was applied in the pursuit to better understanding the general pattern of the sets of data. Since the research mainly focuses on the black letter law, the implementation and their effects, the findings of the research were limited to that perspective excluding all insights and opinion from the very community in which the research wishes to address.

4. Data Analysis

4.1 The Use and Abuse

4.1.1 Disentangling Ambiguity

Observation gathered from case of *Workington Harbour Dock Board v. Trade Indemnity Co Ltd (No. 2)* [1938] 2 All ER 101where the court decided that the bond is in fact, a guarantee and the contractor is held liable base on the fact that '*the rights of the parties should be regulated on that footing'* referring to the true meaning and intention of the contract. An interesting commentary by the court on the contract and its confusing nature is that *'it is difficult to understand'*. The parties' persistence in *'entering upon considerable obligations in old-fashioned forms of contract which do not adequately express the true transaction'* was also criticized. As suggested, it can be observed that uniformity does not exist in the implementation of this instrument. Monitoring is difficult as no specific scheme can be used as a model.

After the decision in the Workington case, it was again disclosed in the Trafalgar House case where a typical example of inaccuracy is the use of the term 'bond' in a contract, initially intended to be regarded as a 'guarantee' by parties in a contract. This consistency was the long awaited benchmark in the effort of setting the needed guideline. In another classic leading case of *Edward Owen Engineering Ltd v. Barclays Bank International* [1978] 1 QB 159 where the differentiation between bonds and guarantees was highlighted. The court described the similarity in nature within the implementation between bond and the letter of credit. The court also established the importance in proving of fraudulent calls before any challenge and injunctive relief on a demand can be made.

4.1.2 Drafting Issues

The critics against the usage of 'recycled' guarantee/bond documents and promoting the use of modern clearer and non-confrontational documents is becoming prominent. In the case of *Oval (717) Ltd v Aegon Insurance Co (UK) Ltd* [1997] 85 B.L.R. 97, the court stated that a need to pay attention to the careful construction of the contracts and commitment towards them should never be underestimated. The case established that it is important to make sure all necessary terms are in the contract, and if such duties are intended they are deemed to be included. This was firmly supported by the decision held in the case of *Marubeni Hong Kong (MHK) & South China Ltd v. Mongolia* [2005] where the Lord Justice Carnwath elaborated that *'if MHK had wanted the additional security of a demand bond, one would have expected them to have insisted on appropriate language to describe it, in both the instrument itself, and in the Legal Opinion'*.

4.1.3 Fraudulent Calls and Threat Issues

A claim for fraudulent call would need to be supported by solid evidence. This would mean that the accuser would also impliedly suggest that the surety is an accomplice and knows that the fraudulence exists. This would be quite difficult to prove if the dispute is between the contractor and the surety. Such occurrence was revealed in *HLC Engenharia E Gestao de Projectos S.A. v. ABN Amro Bank NV*

& Others [2005] *Banque Saudi Fransi (A Company Incorporated in the Kingdom of Saudi Arabia) v. Lear Siegler Services Inc* [2007] where there were clear evidence *'that the beneficiary of the performance bond had made a fraudulent demand of which the bank was aware'*. Unfortunately, evidence is hardly generous in many other occurrences.

The issue of threatening the contractor using on demand call is also alarming. Threats are considered as abusive call and are equally devious as a fraudulent call. Therefore, providing evidence is similarly challenging. In the case of *TTI Team Telecom International Ltd v. Hutchison 3G UK Ltd* [2003], the beneficiary threatened to call on the advance payment bond and it was held to be a threat to an anticipatory breach of the contract.

In a situation where the contractor was expected to fail due to their bankruptcy, the court in *Perar BV v. General Surety & Guarantee Co Ltd* [1994] 66 B.L.R. 72 CA, *Balfour Beatty Civil Engineering & ANR, (Together T/A The Balfour, Beatty/Costain (Cardiff Bay, Barrage) Joint Venture) v. Technical & General Guarantee Company Ltd* [2000] held that insolvency was not a default and would not easily trigger a call for a bond.

4.2 Injunctive Relief

Injunctive relief can be made by the principal (contractor) to avoid the release of guarantee/bond through fraudulent calls. However, the ground for what validates an injunction relief application is seen to be too strict. Evidently, the court would only grant injunctive relief under three circumstances: 1) a clear and proven case of fraud, as established in in the *Edward Owen* case and *Consolidated Oil* case, 2) a potential abusive calls such as a threat to breach a contract by any member of the contracting parties such as in the case of *TTI Telecom v. H3G* case, and 3) the ambiguous and controversial *balance of convenience* such as in the *HLC–Amor* case where the court held that if in any case the obligor is actually entitled for leave to defend to avoid a *potentially irredeemable injustice*. A strict canon is pertinent in giving injunctive relief. Regardless of the risk in having the appealing party misuse the injunction to escape a due obligation, fair opportunity to defend against unfair calls is due in the effort to ensure justice to the deserving party.

4.3 Governing Law

The need for performance bond from the employer's perspective is very important. However, there are need to investigate the criticism from professional bodies' such as FIDIC who claims that the use of 'on-demand' bonds as not adding to the likelihood of high quality performance [9]. Problems needed to be identified and improvement is highly essential. Modern construction contracts such as the JCT Standard Building Contract 2005 Edition [16], governing clauses and forms to properly support the implementation are absent. Furthermore, The FIDIC Condition of Contracts series and [16] agreed with the decision held by the court in the *Perar BV* case and do not consider insolvency as breach of contract. Since the initial objective behind the performance bond was to mainly protect against non-completion (and insolvency may as well be a considerable reason), a well-drafted form of the bond/guarantee contract is vital. The Association of British Insurers (ABI) had continuously supplied the industry with their model of guarantee/bond contracts and forms in an attempt to govern the use of this instrument. Unfair Contract Terms Act 1977 is also available for parties who wishes to draft and construct a bespoke guarantee/bond forms. Unfortunately, they are bound to return to the archaic and biased contents.

5. Conclusion

Performance bond purpose itself as an immediate fund to recover from incomplete work, by reasons of financial or technical disruption on the contractors' side. The construction of contract using archaic wording in the contract has done more damage to the implementation of this tool. The contract exhibits confusing interpretations of terminologies, unclear liabilities and obligations, potential misuse of authority and questionable rights in the contract; contributed to eventual disputes within the tripartite contract. The parties failed to observed the fundamental principles and objective of the instrument. The one-sided interpretations found in the contracts are the cause of lacks in uniformity and inconsistency in the contents of guarantee/bond forms. Moreover, the parties neglected the ideal surface guideline and definition provided by the banking system.

The courts remained firm in dealing with the subject but contribute to minor inconsistency in their decisions, presumably due to the existing inconsistency and lack of uniformity in the contract itself. The court's conservative approach observed in dealing with this bank-origin system has managed to provide a fair guideline to the users in addressing the contents of the contract through its true meaning and the intended purposes. By imposing uniformed definitions and interpretations, establishing transparent definitions within the industry and standardizing scheme through collaboration between ABI and the professional bodies such as JCT, ICE and FIDIC to create an ideal model form could ensure fairness in the implementation of this instrument.

Table of Cases

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