“Warranties, Bonds and Guarantees in the Construction World”

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“Warranties, Bonds and Guarantees in the Construction World” – Introduction

- 9% increase in corporate insolvencies between 2010 Q3 and 2011 Q3, the construction sector has been hardest hit.

- Number of recent court decisions regarding bonds and guarantees.

- Bonds, guarantees and warranties can provide a form of security for the contractor’s performance and also a measure of protection against insolvency.
What is a warranty and why do we have them?

• Contractual - v – collateral

Contractual warranties – what are they?

• Collateral warranties – what are they?

• a contract under which a professional consultant, building contractor or sub-contractor generally warrants to a third party that has complied with its professional appointment, building contract or sub-contract.

• used to create a contract between that party and a party who (for example) funds, buys or rents a property.

• needed to address the absence of a contractual link between parties.

• removes privity of contract issues; difficulties in proving tortious duty of care; difficulty in recovering economic loss in tort.

• Collateral warranties came into existence in the late 1980s-1990s as a result of a series of high profile cases which held that it was not possible to recover damages for negligence in relation to defects in buildings. Damage to buildings was held to be economic loss which is not recoverable in tort. Two landmark decisions establishing the principle – D&F Estates v Church Commissioners [1989] ACC 177 HL and Murphy v Brentwood DC [1991] AC 398 HL.
Warranties – Key characteristics

- Clauses which are common across all construction and engineering contracts – e.g. collateral contract, executed as a deed, no greater liability, IP licence, cap on liability, net contribution clause.

- Requires the warrantor to comply with the professional appointment or building contract it entered into with the developer.

- Some collateral warranties create only a “duty of care” – this offers less protection to a beneficiary as it may not capture all of the professional/construction obligations of warrantor.
Warranties – Common problems and possible solutions

**Problem:** Time - it can often take weeks/months to get these signed and returned – often
long after the building contract has been signed.

**Solution:**
- Irrevocable power of attorney?
- Penalty clause for failure to execute and deliver the required warranties?

**Problem:** Unless there is a contractual obligation to provide a collateral warranty, it is
within a party’s rights to refuse to give one.

**Solution:**
- Ensure that contract requires a collateral warranty to be completed and specifies its
  format or seek to agree the wording at the time of negotiating the building contract.
- Use an alternative e.g. Contracts (Rights of Third Parties) Act 1999?
What is a bond and why do we have them?

• A construction bond is an instrument issued by a bank or insurance company (on behalf of the contractor) to protect an employer against any losses and/or damages sustained by the employer where, for example, a contractor fails to perform its underlying contractual obligations. Bonds are a form of security for the contractor’s performance.

• Broadly two types of bond – default bond and on demand bond:

  ✷ **Default bond** – beneficiary has to prove that there has been a breach of the underlying contract and the amount of loss caused by such breach.

  ✷ **On demand bond** – beneficiary does not need to prove that this breach has occurred or that it incurred any loss in order to call the bond and receive the payment i.e. as good as a cheque.
On-Demand Bonds – Key characteristics

- Primary and independent payment obligation

- Actual amount recoverable/loss suffered may be irrelevant for the call on the bond (Enka Insaat VE Sanayi A.S. v Banca Popolare [2009] EWHC 2410 (Comm))

- Not discharged by material variations or alterations to underlying contract.

- Only proof of fraud defeats a call on the bond (Edward Owen v Barclays Bank International [1977] (CA) BLR1)
Bonds - Common problems and possible solutions

**Problem:** Is there a “default”? Insolvency - *Perar BV v General Surety & Guarantee Ltd* (1994) 66 BLR 72.

**Solution:**
Ensure the underlying contract specifies default.

**Problem:** When does the bond expire?

**Solution:**
Prevent this by including long-stop date.

**Problem:** Call on bond rejected.

**Solution:**
Ensure correct terms and requirements satisfied.
Bonds - Recent case law

**Simon Carves v Ensus [2011] EWHC 657 (TCC), 23 March 2011**
- Employer was prevented from calling upon £18m on demand bond guaranteeing the performance of the contractor.
- The employer’s action in relation to the contract precluded him from making a claim under the bond;
- because the employer had made no claim against the contractor and;
- certified that they accepted the works.

**Hackney Empire Limited v Aviva Insurance UK Limited [2011] EWHC 2378 (TCC) 21 September 2011**
- Contractor in financial difficulties before completing the project with a number of claims outstanding.
- Agreement reached between theatre and contractor whereby theatre paid over sums under a side agreement on account of the contractor’s claims.
- Contractor went into liquidation leaving project unfinished. Theatre’s only prospect of recovery was under a bond issued by Aviva.
- Held – (i) the bond did not extend to the payments made on account and (ii) the payments on account, made without the bondman’s consent, did not jeopardise the bond.
What is a guarantee and why do we have them?

- A guarantee (commonly given by a parent company) is a promise to ensure:
  - that a third party (i.e. the contractor) fulfils its obligations;
  - and/or fulfils those obligations if that third party (i.e. the contractor) fails to do so.

- It’s a contractual promise that creates a ‘secondary obligation’ to support a ‘primary obligation’ of one party to another.

How are guarantees encountered in the construction industry?

- Parent Company Guarantee (“PCG”) in favour of Employer
- PCG provides for protection against breach of contract by contractor
Guarantees – Key characteristics

- Guarantees are contracts and must satisfy the basic requirements of a contract:
  - Offer; Acceptance; Intention to Create Legal Relations; and, Consideration

- Often executed as a ‘Deed’ to overcome any argument about whether good consideration has been given.

- Must be in writing - \textit{s4 Statute of Frauds 1677 – Actionstrength Ltd v International Glass Engineering [2003] BLR 207}

- The Contractor’s Parent Company’s liability will generally never be greater than the Contractor’s liability under the building contract.
Guarantees - Common problems and possible solutions

Problem:
• PCGs are vulnerable if variations are instructed under the building contract.
• Any material variations made to the underlying contract without the parent company’s consent (after the giving of the guarantee) will discharge the parent company’s liability under the PCG itself. *Holme v Brunskill (1878) 3 QBD 495*

Solution:
• PCG to include a provision that the PCG survives any variation under the building contract; or
• Obtain the Parent Company’s written agreement confirming that the existing PCG remains in force and covers the variation to the building contract; or
• Obtain a new PCG.

Problem: Parent Company refuses to give a PCG and provides a ‘comfort letter’

Solution: Carefully examine the wording of ‘comfort letter’; consider a guarantee from other group companies?
The Overview

**Warranties** - Gives that contractual link (i.e. ‘privity of contract’) to Employers, Funders, Purchasers, Tenants.

**Bonds** - Promise to pay cash in the event of a breach – look out for conditions

**Guarantees** - promise to guarantee performance of contractor’s obligations.
NEC 3 - Engineering and Construction Contract

- **Warranties** – no obligation/option to provide Warranties; bespoke amendment needed.

- **3rd Party Rights** – Option Y (UK)3 – party with benefit to be named in Contract Data.

- **Bonds** - Option X13 – optional clause for performance bond in favour of the Employer. Bond amount to be stated in Contract Data. The form of Bond is to be set out in the Works Information.

- **Guarantees** – Option X4 – optional clause for PCG in favour of Employer. The form of PCG is to be set out in the Works Information.
JCT 2011 - Design and Build

- **Warranties** – Part 2 of the Contract Particulars provides the option for Warranties to be provided. The forms of which are to be ‘JCT’s Collateral Warranty – CWa/P&T’

- **3rd Party Rights** – party with benefit to be named in Contract Particulars

- **Bonds**
  - Contract Particulars provide the option for three types of bonds:
    - clause 4.6 provides the option for an Advance Payment Bond;
    - Clause 4.15 provides the option for a Bond for off-site materials and/or goods; and
    - clause 4.17 makes reference to a Contractor’s Retention Bond.
  - The forms of which are in Schedule 6.

- **Guarantees** – no obligation/option to provide Guarantees; bespoke amendment needed
ICC 2011 - Design and Construct

- **Warranties** – no obligation/option to provide Warranties; bespoke amendment needed.

- **3rd Party Rights** – no obligation/option to provide 3rd Party Rights; bespoke amendment needed.

- **Bonds** – clause 10(1) requires contractor to provide Bond in favour of Employer. The form of which is at page 54 of the ICC contract.

- **Guarantees** - no obligation/option to provide Guarantees; bespoke amendment needed.
Wording – What to look out for

- Look beyond the names of these documents - the label attached to a document is not conclusive as to what rights are available – **check the drafting!**

- **Warranties and Guarantees** - usually include a “**no greater liability**” clause – e.g. *Contractor gives warranty to Purchaser* - the contractor has the same liability under the warranty than he would have under the building contract.

- **Bonds** – beware of conditions in an “on-demand” bond – conditions are usually administrative and may include:

  “a **statement that the contractor is in default; enclosing copies of warning notices served on the contractor under main contract, an adjudicator’s award.**”
## Warranties, Bonds and Guarantees - A Summary

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<thead>
<tr>
<th>Question</th>
<th>Warranties</th>
<th>Bonds</th>
<th>Guarantees</th>
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<tbody>
<tr>
<td>Who are they given by?</td>
<td>Members of professional and construction team</td>
<td>Banks, Insurance Companies</td>
<td>Parent Company of employer and/or construction team members</td>
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<tr>
<td>Is it limited to ‘no greater liability’?</td>
<td>Yes – secondary obligation</td>
<td>No – primary obligation</td>
<td>Yes – secondary obligation</td>
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<tr>
<td>Does it provide a remedy against latent defects?</td>
<td>Yes – but be aware of limitation clauses</td>
<td>No – most bonds drafted to expire at end of Defects Liability Period</td>
<td>Yes – but be aware of limitation clauses</td>
</tr>
<tr>
<td>Usually executed as a deed?</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
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THANK YOU

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