Default position

Tim Phipps reports on the use of performance bonds as a means of limiting financial loss in the event of contractor insolvency

In a heated construction market with a strong outlook, it is perhaps surprising that there have been recent reports of contractor insolvency. It could therefore be timely to take a look at the key points to consider when deciding on provisions to mitigate the financial impact of such a default.

Performance bonds (PBs) and parent company guarantees (PCGs) are the most common provisions used to offer security to the employer, beyond the contract itself. However, it is important to appreciate that the two are fundamentally different.

A PCG might be sought where the contracting organisation is trading within a group structure, which is often the case where a parent holding company seeks to limit their risk exposure. Through a PCG, which is often provided at nil cost, the parent company effectively underwrites the obligations of the contractor and is liable to 'step-in' following default.

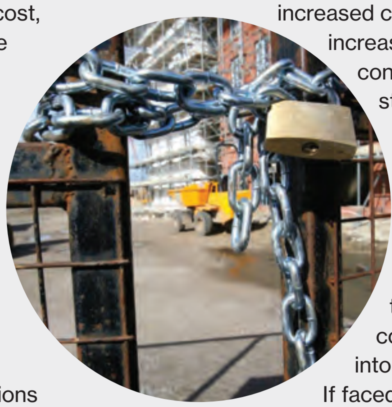
Liability is typically back-to-back with the construction contract and therefore extends beyond completion where a claim could be brought within the limitation period applicable to the contract. There is no financial limit to a PCG, although of course, its worth is wholly dependent on the nature and financial standing of the parent company. If a parent company is not in a position to effectively step into the contractor's shoes and fulfil its obligations under the building contract, then the benefit to be derived through a PCG will be limited. This is important, because in certain circumstances, the ultimate holding company may have been set up for purposes other than contracting. Contractors are often resistant to offering such a guarantee because they represent increased risk to the holding company.

Performance bonds can typically be categorised as being either, 'on-demand' or 'default', with the latter being the most common, primarily due to the relatively high cost and reluctance of organisations to provide on-demand bonds. A default bond is usually provided by a bonding company or financial institution and is designed to provide the employer with financial redress in the event of a contractor default.

The standard limit of indemnity is generally 10% of the contract sum, although this can be increased for a premium. It is usual for the contractor to recover the cost of the PB through the contract, with liability limited not only to the financial cap but also an expiry date, which is often coterminous with practical completion or expiry of the defects rectification period.

To successfully claim against a default bond, there must be a demonstrable breach of contractor's obligation under the contract and financial loss as a result. Insolvency is not always covered, so it is important to check the drafting of the bond carefully at the outset, because this will usually represent one of the greatest financial risks.

Most experienced clients will be in a position to give clear instruction on their bond requirements. Others will look to the professional team or legal adviser (often jointly) for guidance on a project-by-project basis.



Default risk

Market conditions, project context and employer attitude to risk are among the many contributing factors for consideration. A heated market place with fewer tendering contractors, increased competition and rising subcontract costs will increase the risk of main contractor default, as they contend with volatility in subcontract pricing and stretched supply chains.

In terms of project context, the procurement method, complexity of works, value, timescales, contract conditions, experience and standing of the preferred contractor are all factors that will affect the likelihood of default. Similarly, the employer's attitude to risk, financial resilience and exposure to consequential loss will also need to be taken into consideration.

If faced with a defaulting contractor and potential claim against a bond, check that the nature of the default is covered and that the claims procedure is understood. Legal advice should be sought and while PBs provide an important level of limited financial protection, they should not be relied on to cover the full extent of potential financial loss to an employer.

The importance of thorough due diligence during contractor selection cannot be overemphasised, because this may represent the difference between project failure and success. ●

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