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Performance Bonds – Call Me?

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Performance bonds are intended to guarantee a contractor's satisfactory and timely completion of a project. There is no need for the employer to establish or prove that the contractor has defaulted on its obligations prior to making the call. For that reason, enforcing a performance bond is often seen by employers as an attractive option: it can be a means of obtaining a quick cash return, which could alleviate any cashflow pressures that threaten the viability of the project.

Historically, calling an on-demand performance bond has always been seen as the exception, rather than the rule. They were a form of security that was often required, but that was only reluctantly enforced. However, the political and economic shocks felt around the globe since 2020 have started to change this perception.

Supply chain issues, increased costs and insolvency risks have led to employers being more willing than ever to call performance bonds, and we have seen a number of calls being made in the last two years. But experience shows that making a call is never as straightforward as the employer expects. There is often disagreement as to where fault lies and, occasionally, around the bond call procedure itself. The decision to call a performance bond should, therefore, be exercised with caution and only once full thought has been given to the process and potential outcomes. We set out below some of the factors that an employer should consider when deciding whether to call a bond.

The impact on the commercial relationship

Calling on a bond should not be looked upon in isolation but in the context of broader commercial relationships.

Facing a demand on a bond is likely to cause damage to a contractor's banking relationships. The contractor will generally have provided collateral to the bond provider to support the performance bond. Any call will most likely cause the contractor to lose its collateral and will affect its subsequent ability to obtain performance bonds or access finance. This could correspondingly impact its ability to bid for and win future projects.

For that reason, employers should be aware that enforcing a bond is very likely to jeopardise the relationship between employer and contractor. If the parties' goal to complete a project remains aligned, a bond call may not be appropriate despite the contractor's defaults. However, the severe impact on the contractor can also provide the employer with leverage. We have recently advised on a number of projects where calling a bond (or at least threatening to do so) was enough to get the parties to seriously focus on settling their issues and completing the project.

Calling a performance bond can also have negative reputational impacts for the employer. If it becomes common knowledge that a certain employer frequently resorts to making calls on bonds, this could drive up the price at which contractors are willing to do business with that employer in the future and make it harder to obtain similar security.

Requirements of the bond

The cardinal rule is that an issuer of a bond will only pay out under the bond if it is presented with a valid demand. The employer will need to make sure that the demand takes the correct form and is accompanied by the correct documents. It will also need to ensure the demand is served at the right place and by the right method. Employers should ensure they comply strictly with these requirements. Failure to do so will result in the demand not being effective.

Because of this, it is sometimes prudent to liaise with the issuer of the bond before the call is made to ensure that all necessary requirements will be fulfilled. This introduces the risk that the contractor becomes aware of the proposed bond call (and therefore provides it with an opportunity to take preventative action), but it also significantly reduces the risk that the issuer of the bond will reject the form of the demand for being non-compliant.

Finally, the employer should ensure that the correct party is making the demand under the bond. Remember that in a project finance context, security will often have been taken over the bond proceeds. The employer should check the security and assignment documents to ensure the right party is making the demand. Is it the employer? Or is it the bank that has taken security over the bond?

Additional requirements

The underlying construction contract may seek to impose limits around when the bond can be called by the employer. It may also oblige the employer to take certain steps prior to making the demand, for example, giving notice or starting the contractually agreed dispute resolution process. The purpose of such provisions is to protect the contractor against wrongful calls and, in the case of notice provisions, to give the contractor time to take preventative action. Such provisions do not directly affect the obligation of the issuing bank or financial institution to pay on receipt of a valid demand, as the performance bond is autonomous from the underlying contract, but it may provide the contractor with grounds to claim that the employer has breached the provisions of the construction contract. It may also allow it to prevent the call being made or to prevent the issuer making payment under the bond.

Where the project in question is being financed, the employer should check the finance documents to establish whether the lender consent is required prior to making the call. The finance documents may also impose limits on what the employer can do with the proceeds of the bond, which may impact the employer’s decision to call the bond.

The best time to call the bond

Because calling a bond is likely to have a negative impact on the commercial relationship, many employers wish to delay making the demand as long as possible. However, it is not uncommon for the value of the bond to step down over time as the project progresses. That being so, if an employer is entitled to make a call it will be in its interests to do so at a point in time when it will obtain maximum value.

Performance bonds are also usually time limited, with a specified expiry date. Employers should be aware of the relevant expiry dates and be ready to enforce them prior to expiry if they will not be renewed. Most construction contracts will expressly permit this, although conditions may be imposed around the employer's use of the bond proceeds.

It should be remembered that it may take several days or weeks to prepare for and properly call a bond. In one recent example, the original wet-ink demand had to be served on the issuing bank which required the document to be flown around the world so that it could be signed by the relevant individuals and then delivered. The decision to make the call should not be left to the last minute.

Contractor challenge

It is not unusual for demands on performance bonds to be challenged by contractors, either by seeking to prevent the issue of the demand itself or to prevent payment on the demand. In fact, the contractor often has little to lose by making the challenge, as the associated legal fees will likely be significantly less than the amount to be paid out under the bond. The potential for such a challenge, and related proceedings, should be a key consideration for any employer considering a demand.

Employers should, in particular, consider the most likely forum(s) for challenge and prepare accordingly. If the contractor seeks to prevent issue of the demand, it will need to consider what jurisdiction is provided for in the underlying construction agreement and, in particular, whether it is required to seek redress through arbitration or via a particular national court. Alternatively, if the contractor seeks to prevent payment by the issuing bank, it will be more likely to seek an injunction from the courts of the jurisdiction where the issuer is located. The position is often complicated by multiple bonds being issued by issuing banks or financial institutions in different jurisdictions.

The grounds on which a court or tribunal may intervene to prevent a call may differ from jurisdiction to jurisdiction, hence the need to seek local advice. In England, the general principle is that the court will be very reluctant to interfere in the process of a bond call. This is because the bond is recognised as an independent contract, separate from the disputes between employer and contractor. As a matter of English law an injunction would traditionally only be granted where the demand is obviously fraudulent and that is known to the bank. The court must be satisfied that the employer had no honest belief that it was entitled to make a demand. In more recent times, there has been movement towards granting an injunction in situations where it has been established that the employer is precluded from making the demand by the terms of the underlying contract.

Such considerations are not straightforward. The employer should seek advice in advance of a bond call as to the likely approach of the relevant court or tribunal and the grounds upon which they may restrain a call. The need to seek and obtain this advice should be built into the bond call timeline.

In all cases, employers should identify and collate evidence of a contractor’s breaches in order to be able to demonstrate to a court or arbitral tribunal that a demand is justified and properly made. Making time to consider the justification for a call, and gathering the relevant evidence, will be key not just to defending the call initially, but also to any subsequent dispute between the employer and contractor.

Wrong call

If the demand is satisfied, but calling the bond is later determined to be wrongful – for example, because it is ultimately decided that the contractor was not at fault and that the employer was not, therefore, entitled to call the bond – the employer will be required to repay the proceeds from the bond with interest. The employer may also have to compensate the contractor in damages for any other loss that it has suffered.

For this reason, calling an on-demand performance bond should not be seen as free money. However, it may be seen as money now, which could provide a significant benefit in the short term, even in the face of long-term risk.

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