



In light of the Carillion collapse, is it time to veer away from on-demand or performance bonds?



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# **In light of the Carillion collapse, is it time to veer away from on-demand or performance bonds?**

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*Seb Oram*

# Agenda

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1. How do bonds work?
2. Why is the Carillion collapse relevant?
3. If not bonds, what are the other options?
4. Should we veer away?

# 1. How do bonds work?

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- An obligation by a third party to pay money upon a defined event
- The possible events:
  - Performance bonds vs. payment bonds
  - Conditional vs. 'on demand' bonds
- Performance bonds provide security for (contractor's) obligations
- Their only function is to protect against insolvency
- Their essential purpose is to permit remobilisation of the project

## Inter-departmental report (Nov 1996)

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Departments should not normally employ bonds but should instead rely on effective pre-qualification and vetting procedures.

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*“The Use of Performance Bonds in Government Construction Contracts”*, Report of an inter-departmental working group for the Department of the Environment (London, HMSO; Nov 1996)

## 2. Why is the Carillion collapse relevant?

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- Contractor failure triggered by familiar construction problems
- Size and effect of the failure
- Demonstrates problems for client *and* supply chain
- Government not aware of contractor's financial distress
- Failure may occur on a *different* project

## Select Committee Report (July 2018)

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[A Cabinet Office review] should take note of the weaknesses in the Government’s approach. These include **the Government’s surprise** that Carillion issued a profits warning in July 2017....

The Cabinet Office should also ensure that it learns lessons from this crisis about how to quickly collaborate with local government to **deal with the issues raised by a collapse** such as Carillion.

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*“After Carillion: Public sector outsourcing and contracting” (HC 748)*

## 2. Why is the Carillion collapse relevant?

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### What can we take from Carillion?

- ✓ Solvency checks require more than project-specific monitoring
- ✓ Need to respond quickly to keep projects on track
- ✓ Adequate contingency planning
- ✓ Proper (client) funding of financial protection measures

## 3. What are the other options?

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### **Perceived 'problems' with performance bonds**

- Limited (usually) to 10% of contract value
- Time-limited – cannot last throughout limitation period
- Cost?

## 3. What are the other options?

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### **Actual problems with on-demand bonds**

- Banks require 100% cash collateral for bond amount
- Risk of improper call on bond; may prejudice solvency of contractor

## 3. What are the other options?

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### **Actual problems with performance bonds**

- The most common form (ABI model) operates as a guarantee; need to prove breach
- Employer will not know his final loss until a termination account produced
- Time-limited – cannot last throughout limitation period
- Need for litigation (against bondsman and/or creditor) to enforce
- Cost?

### 3. What are the other options?

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#### The ABI model bond

*“the Guarantor guarantees to the Employer that in the event of a breach of the Contract by the Contractor the Guarantor shall... satisfy and discharge the damages sustained by the Employer as established and ascertained [under the construction contract]”*

- Going into insolvency is not itself a breach of contract: Perar BV v. General Surety & Guarantee Co (1994) 43 ConLR 110 (CA)
- The relevant breach: failing to pay termination account: Ziggurat (Claremont Place) LLP v. HCC International Insurance Co PLC (2017) 176 Con LR 161 (TCC)

## 3. What are the other options?

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### Illustrations of problems

- Situation 1:

Contractor is removed from site and *then* becomes insolvent; contractor says it was because of employer's action (*i.e.* entitlement to terminate is disputed)

- Situation 2:

Termination account is presented; contractor disputes it and refers dispute to adjudication (*i.e.* obligation to pay, and breach, are disputed)

## 3. What are the other options?

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### **The other options: security**

- Retention provisions (with clause that can be set off against any sum due from contractor)
- Parent company guarantees
- Insurance against contractor default (*i.e.* latent defects)?

### **The other options: ancillary**

- Project bank account, held on trust
- Vesting clauses (materials and plant)
- Sub-contract step-in provisions / direct warranties
- Project partnering (spread the risk)

## 3. What are the other options?

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### Insolvency Law 'anti-deprivation rule'

- Cannot, by contractual provision, evade priority of payments under Insolvency Act 1986
- But provisions with legitimate commercial basis will be upheld: Belmont Park Investments PTY Ltd v BNY Corporate Trustee Services Ltd [2011] UKSC 38, [2012] 1 AC 383 (SC)

## 4. Should we veer away?

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- No, they provide the best, quick source of cash
- Recognise the principal purpose of the bond: remobilization
- Tailor your contractual provisions to reduce delays after calls
- Not an alternative to proper contingency planning

### **BUT**

- Need a fair balance of rights – also protect against employer failure
- A project bank account

## 4. Should we veer away?

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### Tailoring your contract

- Effective valuation/payment mechanisms (assessed against work completed)
- Permit 'on account' demands as part of termination account
- Retention (and set-off) provisions
- Effective termination provisions (halt payments to contractor; vesting/forfeiture)
- In the *bond*, exclude the right of adjudication
- Collateral contracts with subcontractors/professionals, with effective step-in provisions

## 4. Should we veer away?

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### **Effective contingency planning**

- Who are the 'key persons' in design team/sub-contractors?
- How do you establish who has been paid?
- Contracts should grant access to designs, BIM data, financial information
- Will a new contractor step in? Latent defects insurance?

# Conclusions

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- Wide 'on demand' bonds operate unfairly
- Performance bonds serve an essential function in protecting against insolvency
- Usually a one-sided solution (contractor can rarely ask for one; insolvency may have impact up and down chain)
- To be effective, contractual provisions may need to be tailored
- Critical need for proper contingency planning



It's time for *Questions & Answers*

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Questions welcome

# The Speaker

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