H M TREASURY

GUIDANCE

Central Unit on Procurement

No. 48 Bonds and guarantees

This is one of a series of guidances prepared and issued by CUP on purchasing and supply procedures and practices. Its use is not mandatory, but a statement of good professional practice. Departments should consider incorporating it into their purchasing and supply manuals.

References to "the EC rules" are to the EEC Treaty, the EC procurement directives as implemented in UK legislation, rulings of the European Court of Justice and other relevant EC law. Departments can obtain advice and guidance on the EC rules from PSP Division, HM Treasury.

1. INTRODUCTION

1.1 A bond is a legally enforceable financial guarantee given by a third party (the guarantor) to a purchaser (the client) to guarantee the obligations of a supplier of goods, works or services (the contractor) under a contract. The guarantor agrees to pay the client a sum of money if the contractor defaults on its obligations, The purpose of requiring a bond is to help the client meet the extra expenses to remedy the default and/or complete the contract.

2. SCOPE

2.1 This guidance covers some of the practical considerations when using bonds, the issue of calling 'on demand', and deals with five types of bond or guarantee:

-unconditional on-demand bonds;
-performance bonds;
-parent company guarantees;
-advance payment bonds; and
-retention bonds.

Departments are strongly advised to seek appropriate professional and legal advice on the use, choice, and drafting of bonds for a particular contract.

3. PRACTICAL CONSIDERATIONS

3.1 Bonds are generally provided by the financial market, either by a bank or a surety company. The contractor and the guarantor will seek to establish the terms and conditions under which the bond can be called. Departments, for their part should want to know that the guarantor issuing the bond is a sound, reliable and responsible corporate body and be satisfied that if there is need to call the bond for payment the guarantor will comply promptly.

3.2 There are at present no standard forms of bond for use in government. The wording of commercial bonds can vary depending on which organisation is providing the bond, who is involved in drawing it up and what the bond is expected to deliver. There is often intense negotiation over the precise wording of bonds and leqal advisers should always be involved.

3.3 Generallv, the additional cost of a bond is relatively small in comparison with the price of the contract. This will depend to some extent on the terms and conditions the client requires (whether the bond is on-default, or more onerous, on-demand) and the degree of risk the guarantor attaches to the ability of the contractor to give a counter indemnity and to repay any sum that is called.

3.4 The size of the bond is very important, because this impacts on the contractor's bonding capacity. To require a large value bond has the same effect as an equivalent number of smaller bonds. Generally, contractors will be unwilling to use up their bonding line on large bonds for smaller projects and this can restrict competition.

3 5 In most cases, on-demand bonds are provided by banks who may regard them as open credit notes and may require provisions to be made from borrowing facilities against contingent liabilities. This can affect the contractor's financial resources and its ability to compete for and undertake other work. A requirement for an on-demand bond may therefore deter firms who would otherwise have

tendered for the contract and/or inhibit their ability to tender in the future.

3.6 In raising a bond or a line of bonding credit from a bank or a surety company, the contractor may undergo independent professional financial vetting, Whilst the extent of the cover which the market is willing to provide may give some indication of the contractor's financial standing and prospects, the procedures applied vary greatly and will not always involve a detailed check of performance or record.

3.7 A guiding principle of procurement best practice is that normally a contract should not be placed with a contractor if there are reasonable doubts about the contractor's ability to meet the terms and conditions of the contract satisfactorily. Such doubts may arise in relation to the adequacy of the contractor's management and technical resources to deliver on time and to the required quality standard, or where information available suggests the contractor may have inadequate financial resources with consequent risk to Exchequer funds

Bonds are not always necessary and are no substitute for considered judgements about the risks of a particular contract and the capabilities and financial resources of the available contractors. A decision to require a bond must be part of an overall approach to risk management and should take account of available measures to reduce the risk of default, including a proper prequalification of tenderers. Departments will need to exercise careful judgement in assessing the costs and benefits of using bonds, many of which may not be easily quantifiable.

4. UNCONDITIONAL ON-DEMAND BONDS

4.1 The terms and conditions of a bond determine the circumstances and mechanism by which the bond can be called. An unconditional on-demand bond allows the client to call the bond at any time. Unconditional on-demand bonds are only provided by banks and are in effect certified cheques.

4.2 Because they are not linked to the performance of the contractor, unconditional on-demand bonds can be called by the client at any time and without having to show any cause or justification The findings of the courts have been consistent that there is no implied requirement for the calling to be fair or reasonable. Unconditional on-demand bonds can, therefore, be used unfairly, usually as a threat to persuade the contractor to do something it would not otherwise do, or which it is not contracted to do.

Unconditional on-demand bonds are essentially unfair and Ministers have said that they should not be used in government procurement.

5. PERFORMANCE BONDS

5.1 A performance bond is usually provided at contract award, for an agreed percentage of the total contract value (normally 10 per cent). Normally, the value does not reduce, but performance bonds should have an expiry date (not necessarily a calendar date - it can be linked to an event so that time slippage is automatically taken into account). If the value of the contract increases, or the duration of the contract extends, then the bond may need to be amended accordingly.

A **performance bond will not of itself ensure that contracts are carried out efficiently and to time, but it will be one of a number of commercial pressures on the contractor to perform well.** A **performance bond can provide some compensation if the contractor defaults on its obligations.**

5.2 There are two basic forms of performance bond: the "conditional **on-default** bond" and the much more onerous "conditional **on-demand** bond".

Conditional on-default performance bonds

5.3 Usually these can be called only following a serious breach by the contractor of the agreed terms and conditions of the contract (which will include becoming bankrupt and would normally allow the client to terminate the contract).

5.4 Conditional on-default performance bonds are fairly common within UK industry and are mainly provided by surety companies. They have been criticised because they are often written in outdated and obscure language. This has meant that when calls have been made, guarantors have sometimes looked to the wording of the bond for reasons not to pay.

Properly expressed conditional on-default performance bonds provide a third party guarantee that the contractor will not default from a contract it has freely entered into. They should be required where there are identifiable risks of default by the contractor, subject to value for money considerations. Departments should seek legal advice that the wording clearly expresses the true transaction and not assume that "traditional" wording will be appropriate. They must be prepared to pursue this with the guarantor.

Conditional on-demand performance bonds

5.5 These are bonds which although 'on-demand' should include within their terms and conditions:

-a mechanism for calling (so that the bond may be called only if certain procedures have been followed, requiring senior personnel within the client's organisation to approve the calling):

- -a requirement for the client to identify the reason for calling (which reason may be questioned and contested); and
- -a cooling off period (during which the contractor may remedy the default).

5.6 There is a place for the use of conditional on-demand performance bonds where the costs or other consequences of default by the contractor are very high and, provided it is properly called, the guaranteed sum will be paid without risk of dispute. Such bonds retain some features of an unconditional on-demand bond. They can be called at the sole discretion of the client, but only if the agreed conditions for calling are met. This should prevent the client from acting in an arbitrary or unreasonable way and protect the contractor from the bond being called without the due and proper consideration of responsible people in the client's organisation. A cooling off period should allow the contractor time to investigate and remedy a default,

Departments should be aware of the burden that on-demand bonds can place on a contractor. Conditional on-demand performance bonds should be used sparingly on high risk and/or high value projects where the costs and/or other consequences of default by the contractor are high and only after careful consideration, including appropriate professional and legal advice.

6. PARENT COMPANY GUARANTEES

6.1 This form of guarantee is given by a parent company (or holding company) to guarantee the proper performance of a contract by one of its subsidiaries (the contractor), and can only be given where the contractor is owned by a parent company or is the subsidiary of a larger group. Such a guarantee is free of cost to the client, but may give less certainty of redress than a bond because it is not supplied by an independent third party. However, whilst accepting less independence, parent company guarantees for the proper performance of the contract can be more advantageous than bonds. Rather than receiving a fixed amount in compensation, the parent company is obliged to complete the contract (see paragraph 6.3). Costs for completion are borne by the parent company - and these costs may be significantly more than the compensation provided for in a bond. In addition, further recompense can be sought for time delays in completion through the normal clauses incorporated in the contract.

6.2 The conditions of a parent company guarantee will usually give the parent company the opportunity to remedy any default within a period of notice before the guarantee is called. The liability can take several forms including a financial guarantee of completion of the project itself or the employment of another contractor to complete the project.

6.3 Where problems arise under the contract, this form of guarantee should discourage the parent company from putting the contractor into liquidation solely to avoid losses in completing the project or in paying damages for late or non-completion. Provided that the parent company is financially sound and the guarantee is properly worded, the performance and the completion of the contract can be safeguarded, but the way in which the project is completed if the contractor defaults can to some extent, be at the discretion of the parent company.

6.4 Because the financial strength of the parent company may be linked to that of the contractor, a parent company guarantee will be acceptable only if the parent company (or holding company) is financially strong and its financial resources are largely independent of those of the contractor.

Departments should be aware when vetting the contractor that a parent company guarantee is only as good as the parent company (or holding company) itself. If the financial position of the holding company is inadequate, then the guarantee should be given by the ultimate parent company, if this is justified by its own financial standing.

7. ADVANCE PAYMENT BONDS

7.1 The Treasury has issued guidance explaining why advance payments should be avoided (see DAO letter 8/93, dated 2 June 1993) and has informed the PAC that "any advance payment made under a contract should be secured by a bank guarantee".

1.2 Where the advance payment reduces with time as, for example, stage payments are made against goods and/or services delivered under the contract, then the value of the guarantee should reduce to reflect the outstanding amount of the advance payment.

7.3 Normal practice is to require a conditional reducing on-demand advance payment bond issued by a bank so that, provided it is properly called, the guaranteed sum will be paid without risk of dispute.

Advance payments should be avoided wherever possible. In all cases where they cannot, they must be independently secured by a conditional on-demand advance payment bond issued by a bank. Departments should take legal advice that the wording expresses the true intention of the transaction.

8. RETENTION BONDS

8.1 These bonds are still rare in the UK but their use is likely to increase. They are provided so that contractors (and their subcontractors) may be paid without the client deducting retention money. As work is completed, the contractor is paid fully under the

terms of the contract. Normal practice is to provide conditional retention bonds issued by a surety company that increase in value as payments are made in accordance with the contract. The client is protected against default at the end of the defects liability or guaranteed maintenance period up to the amount of the bond.

8.2 The traditional retention system is to withhold a percentage from payments made during the course of the contract to accumulate a fund that is available to the client if the contractor fails to rectify defects in accordance with the contract (usually 5.0 per cent of the value of the contractor's work up to certified completion, reducing to 2.5 per cent up to final acceptance). Usually, the first half (in legal terms a "moiety") of retained money is paid to the contractor on certified completion and the second on final acceptance that the contractor has fulfilled its contracted obligations. The cost of that anticipated loss of cash flow is reflected in a contractor's tender pricing. Retention bonds give contractors better and more certain cash flow through full payment at all stages (without the deduction of retention money).

8.3 The use of retention bonds transfers financing cost from the contractor to the client (who is required to pay in full earlier) and will pass cash flow benefits to the contractor. Their use will only result in a lower cost to the client if contractor are prepared to reduce their tender prices accordingly. The option to offer a retention bond should be included in the tender documents at enquiry stage.

The conditions of a retention bond should relieve the client from failure by the contractor to rectify defects in accordance with the contract up to the value of the bond. Departments will need to consider the balance of costs and benefits in deciding whether to require and/or accept retention bonds. When used they should be conditional on-demand, issued by a surety company. Departments should take legal advice that the wording expresses the true intention of the transaction.

9. USING BONDS IN BUILDING AND CML ENGINEEBING CONTRACTS

9.1 This guidance deals with the use of bonds and guarantees for all types of procurement. Further guidance on using bonds in **public sector works projects,** and on documentation, is being considered by an inter-departmental group chaired by the Department of the Environment, who expect that it will be available later this year.

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