



Construction A-Z – Guarantees (and Bonds)

Guarantees and bonds are common on many construction and engineering projects, both in the UK and internationally. They are often required by the employer as a means of security against contractor non-performance and, as such, are generally referred to as "performance security".

Although this note aims to give a comprehensive and practical overview of guarantees and bonds, they are complex security instruments, and it is good practice for parties to seek specialist legal advice before deciding which performance security is most appropriate and how to document it.

Types of performance security on construction projects

The requirement to provide a guarantee or a bond will typically be set out in the building contract and is often a precondition to the employer entering into the building contract. Below is a non-exhaustive list of guarantees and bonds commonly used on construction projects:

1. Performance Bond (or Guarantee)

These are the most common forms of performance security on construction projects. The guarantor (typically a bank, insurer or other financial institution) undertakes to answer for the non-performance of obligations under the building contract (such as completing works) by a third-party beneficiary (typically the contractor). If the contractor defaults, the guarantor is required to pay the employer up to the maximum amount stated in the bond – usually 10% of the contract sum.

There are two types of performance bonds:

- On-demand bonds: These can be called upon without the employer needing to prove that the contractor has breached the contract or obligation to which it relates. To enforce the bond, the employer must simply issue a valid demand, upon which the guarantor is required to pay out the amount requested. The building contract or bond documentation may require the demand to be in a specific prescribed form or to contain particular information to be valid. Employers should ensure they comply carefully with these formalities (and seek advice on the requirements if unsure) to ensure that the demand is valid and effective. For this reason, on-demand bonds are less frequently available and more costly than conditional or default bonds.

- Conditional or default bonds: These require the employer to establish not only that the contractor has breached its obligations under the building contract but that the employer suffered a loss as a result before being entitled to claim payment under the bond. This is usually achieved by way of an adjudicator's decision or a court/arbitrator's judgment in the employer's favour.

Contractor insolvency considerations:

It is worth highlighting that contractor insolvency is not an automatic event of default under the standard JCT suite of contracts (unless varied by a schedule of amendments). Insolvency alone will, therefore, not necessarily entitle the employer to call upon a conditional bond. Instead, the employer would need to terminate the contract (once the contractual definition of insolvency has been triggered), engage a replacement contractor to complete the works, and then call on the bond only once it can quantify its losses by demonstrating the additional cost of completing the works compared to the original contract sum. This offers the employer no immediate assistance from a cash flow perspective, so parties may, therefore, wish to include bespoke drafting to ensure that the bond can be called upon in the exact circumstances the parties intend.

2. Advance Payment Bond (or Guarantee)

On some construction projects, the employer agrees to pay the contractor a substantial portion of the contract sum up front, even before the contractor starts on site. This may be relevant to enable the contractor to mobilise on-site, order high-value plant or materials or manufacture sections or components for use on the project off-site.

Advance payments present a significant risk to the employer, as they would suffer a loss if the contractor were later unable to complete the works for any reason (including insolvency). An advance payment bond goes some way to mitigate that risk, as it secures the employer's payment against default by the contractor. The bond allows the employer to recover the sums paid in advance from the issuer of the bond (bank, insurer, etc), who is independent from the contractor.

Advance payment bonds are usually provided on an "on demand" basis, i.e., without any preconditions needing to be met. Typically, the sum under the bond will also reduce as the works progress, but it is crucial that the bond is carefully drafted to accurately set out the circumstances for payment and any requirements, such as the need for the contractor to provide vesting certificates for certain plants and materials.

3. Retention Bond

Standard form building contracts typically provide for the retention sum to be withheld from each interim

payment as a means of protection for the employer where [defects](#) are not rectified by the contractor. Usually, half of the retention is released upon practical completion, and the other half is released at the end of the rectification period. Instead of withholding retention monies, the employer may request that the contractor provide a retention bond, which is issued by an independent surety in favour of the employer.

The retention bond allows the employer to have access *on demand* to a sum of money under the bond in the same way as it would have if the retention had been withheld in the usual way. The amount under the bond will be the same as the amount of the retention that would have been otherwise deducted from an interim payment.

4. Parent Company Guarantee (“PCG”)

A PCG is another form of security that may be required by an employer to protect against contractor default, particularly where the contractor is a small entity within a larger, financially stable group of companies. The guarantee is provided by the contractor’s parent company in favour of the employer to secure the performance of the contractor’s obligations under the building contract. If the contractor is in default, the employer can rely on the guarantor to remedy the breach, complete the works or/and pay damages suffered by the employer as a result of the contractor’s default.

In some cases, PCGs may also be required from a subcontractor’s parent company or (occasionally) from the employer’s parent company to the main contractor, essentially as a payment guarantee.

There is no industry-standard form or “off-the-shelf” PCG, so these need to be drafted on a project-specific basis to reflect the parties’ specific requirements.

Tip – Practical considerations when drafting and negotiating guarantees or bonds!

It is important to adapt the drafting of a guarantee or bond to reflect the scale and complexity of the project as well as the parties’ requirements and intended timescales. Generally:

- The necessity for (and form of) any guarantee/bond should be discussed at an early stage. A recurring problem in practice is that (amidst the myriad of other legal and technical documentation required for the project), the preparation and negotiation of the guarantee/bond wording are left to the last minute. This can give rise to difficulties, particularly if the issuer’s consent to the precise wording is only sought shortly before the intended date for completion of the building contract. The Association of British Insurers model form of bond is often a useful starting point for conditional bonds but (like most off-the-shelf construction documentation) has its limitations and is not suitable for all projects.
- The guarantee/bond should contain clear language defining trigger events and (where relevant) the process for submitting a demand. Strict compliance with these provisions is crucial (and time-critical!) when the guarantee/bond becomes needed.

- The wording of the guarantee/bond should be consistent with the wording adopted in the rest of the construction documentation. For example, references to events of default or insolvency under the guarantee/bond should mirror the definitions in the underlying building contract.

Remember – Bonds and guarantees are only two methods of managing risk and guaranteeing performance on construction projects. Other options, such as robust [collateral warranties with step-in rights](#), enhanced retentions and placing funds in escrow may be more appropriate depending on the specific requirements of a project.

Contact our construction law team

Please get in touch with our [Construction team](#) if you would like to discuss appropriate forms of guarantee or bond or for advice on performance or payment security in relation to your construction project at amy.lewis@LA-law.com.