

# **„Guarantee and Bond as Securities in Project Business“**

Project Development II (Legal aspects)

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# Introduction

## What is Security?

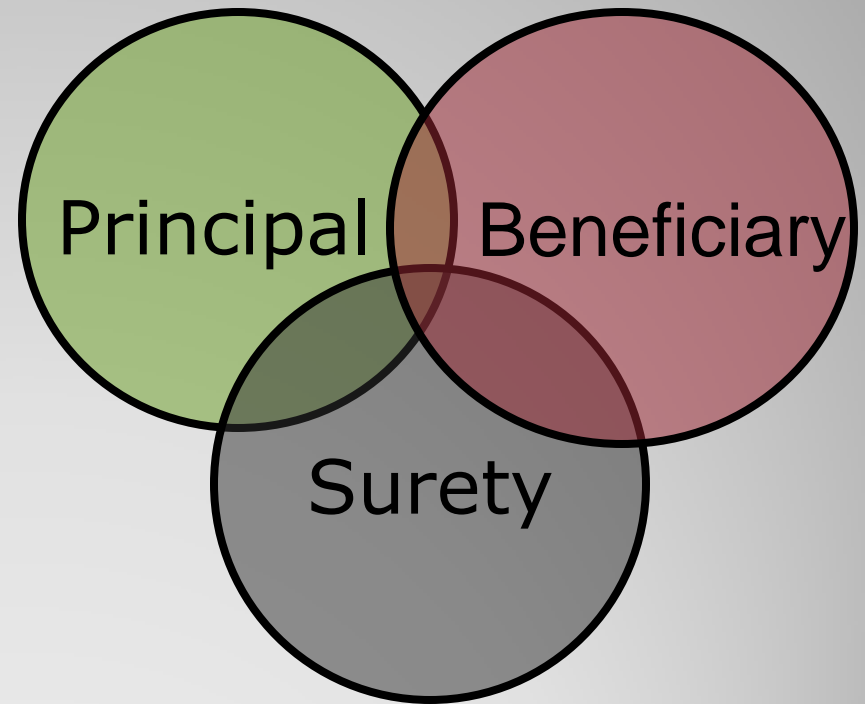
Security is any instrument that prevents possible loss or may serve as compensation in case of a loss. Thus it may reduce the risk in cases of credit.

- **Bond** and **Guarantee** are classified as personal securities.
- **Bonds** and **Guarantees** are considered as profitable business venture for financial institutions.

# What is Bond?

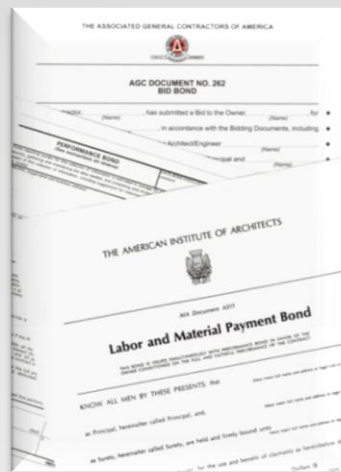
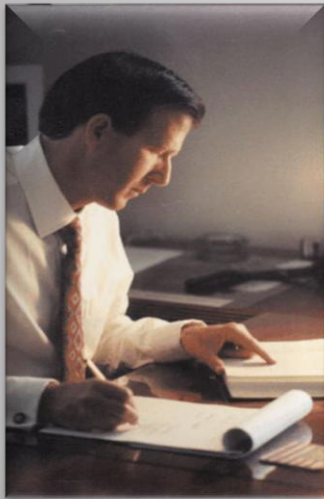
Bond is an agreement which involves 3 parties:

- Principal (Contractor)
- Beneficiary (Client)
- Bondsman, Surety or Guarantor



# Bond as a Security

According to this contract, Beneficiary is protected by Surety, Surety promises to pay sum to Beneficiary, in case Principal fails to perform the contractual liability to Beneficiary.



# Guarantee as a Security

- Three-party Contingent liability agreement under which a Guarantor agrees to be directly or **collaterally** responsible for the Contract obligation fulfillment of a Contractor to a Client in case the Contractor defaults or fails to fulfill its part of a deal.
- Signing a guarantee a guarantor is like signing a **blank check**. Unlike a bond.
- Guarantee may refer to things as well as **persons** and, to be legally enforceable, must be in writing.

## **"Section 443" (BGB)**

### **Guarantee of quality and durability**

- (1) If the seller or a third party gives a guarantee for the quality of the thing or that the thing will have a specified quality for a specified period (guarantee of durability), then, if there is a claim under the guarantee, the buyer, notwithstanding his statutory claims, has the rights given by the guarantee upon the terms set out in the declaration of guarantee and in the relevant advertising in relation to the person who granted the guarantee.
- (2) To the extent that a guarantee of durability has been given, there is a presumption that a material defect which appears during the guarantee period triggers the rights under the guarantee.

# Nature of Bonds

- *Payment bonds*

Guarantee that Contractor will pay for services and materials. It guarantees that all suppliers and subcontractors will be paid for work performed.

- *A specific obligation (Bid bonds)*

Promise by a Sub-contractor not to withdraw a tender. Or a guarantee that a contractor will enter into a contract.

# Nature of Bonds (Cont'd)

- *Performance bonds*

Most common type of bond, in which every aspect of the Contractor's performance is guaranteed. Normally such bond provides 10% of the contract sum.

Performance bonds can be two types:

- **Conditional**
- **Unconditional or Demand bonds**



# Types of Bonds

- *Conditional bond*
  - In order to call for payment the Client must provide evidence of both the Contractor's default and the resulting losses suffered by its company.
  - In practice, a conditional bond may require litigation before any payment can be obtained.
- *Unconditional or Demand bond*
  - Client can call upon the surety for payment in case of possible fraud by the Contractor. Unless the evidence is clear, payment must be made.
  - Commonly used in international contracts.

# Sources of Bonds

In the construction projects such bonds can be provided by two sources:

- *Parent Company Guarantee*

Contractual performance of one company within corporate group is underwritten by other members of the group.

- *Bank or Insurance Company*

Some organizations are specialized in providing protection against contractual failures.

# Surety Company Checklist

- ✓ Good character
- ✓ Experience matching contract requirements
- ✓ Financial strength
- ✓ Excellent credit history
- ✓ Banking relationship
- ✓ Line of credit
- ✓ Necessary equipment



# Practical Example (Maintenance bond)

**Project:** Stormwater Treatment Practice (STP)

**Beneficiary:** City of Melbourne  
(BREVARD COUNTY, FLORIDA)  
- Client

**Principal:** „Construction company“ - Contractor

**Surety:** „Insurance company“



- **Maintenance bond**

Guarantee that a contractor will provide facility repair and upkeep for a specified period of time.

# Practical Example (Maintenance bond)

## Bond Overview

- Total amount required for bond is **10%** of construction costs.
- Length of the bond is **2 years**, which starts after completion and final approval of the STP.
- Requirements for notice of defect or lack of maintenance include the obligation of Principal to correct the defect.
- If Principal fails to correct the defect, the Surety is liable to insure Principal's performance within **60 days**.

# Practical Example (Maintenance bond)

- If Principal and Surety are not able to correct defect within **60 days**, Client has the right to correct such defect, and then the Principal and Surety are obliged to pay all costs including *engineering, legal and other costs, also direct and consequential damages.*
- Client has a right to contract another party to correct the defect, in this case Principal and Surety are liable for these costs, e.g. Lowest bid
- Client can also start legal proceedings for collection of amount with rate of **6%** of the sum per annum.

# Release of Surety

- The Surety cannot be held responsible unless all material facts were disclosed, when guarantee was entered into.
- Any material variation in the terms of the main contract releases the Surety's obligation, since it changes the nature of what is guaranteed.

# Conclusion

- Bond is a legal tool, which prevents Client from possible or occurred losses or damages.
- Bonds are very effective in construction industry, because of great number of financial risks involved.
- Bonds have the following specifications, which can vary depending on project:
  - Length of time period,
  - Amount to be paid,
  - Requirement of notification,
  - Enforcement of the bond

# Conclusion (Cont'd)

## Benefits

- ✓ A company must be thoroughly investigated before they are issued a bond.
- ✓ By requiring bonds, the owner is getting a guarantee that the company is financially qualified to take on the project and has a solid performance history.
- ✓ Projects that are bonded are much more likely to be completed without incident, because of the huge financial and legal penalties contractors face for failing to perform.

# Conclusion (Cont'd)

## Disadvantages

- ✓ The bonding premium might range from 1-2% of the project price.
- ✓ This cost is passed on to the owner in the form of higher bids.
- ✓ For contractors, bonds can be difficult to obtain. New companies might not have the required performance history to qualify and those will have limited bonding capacity.

# **Thank You For Your Attention**



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