A NEW NORMAL IN CONTRACTUAL PRACTICE

INTRODUCTION

Achieving greater collaboration between clients, consultants, contractors, and the supply chain is at the heart of the change that is needed to transform the construction sector. Current contractual practices often inhibit a spirit of collaboration and lead to the creation of systemic risk in the industry.

Although standard forms of contract such as JCT and NEC have been in place for years, designed to fairly allocate risk between project stakeholders, it is not uncommon to see amendments doubling the number of pages in the standard forms. The result is that some of the risk is shifted onto others in the supply chain, often creating inefficiencies and frictions, which leads to a downward spiral of extra costs, lower margins and widespread disputes.

Creating a new ‘normal’ in contractual practice, where the focus is on managing rather than passing on risk, is essential for a more collaborative and sustainable sector. As a general principle, risks should be acknowledged and, to the extent that is practicable, managed by the party best equipped to do so.

Build UK has developed a recommendation on contractual practice, identifying a number of terms which should not be included in contracts. The aim is to form a common ground between clients and the supply chain, encouraging a fairer allocation of risk and resulting in better project outcomes. This is a non-binding recommendation, and Build UK members are free to negotiate their own respective contract terms.

There was significant consultation in developing the recommendation – including obtaining specialist legal advice – resulting in strong support throughout the industry.

The recommendation was welcomed by the Construction Leadership Council (CLC), with Chairman Andy Mitchell saying *“if we are to improve industry performance and strengthen supply chains, we need fairer contract terms and a better approach to apportioning risk, based on who is best placed to manage this. These recommendations are a first step towards fairer and more responsible contractual practices, and the CLC will be encouraging the industry to adopt them”.*

For each of the following terms identified in the recommendation, this guidance provides the context, outlines the reasons why they should be avoided, and puts forward recommendations on how to more effectively manage the underlying issues:

- Fitness for purpose
- Unquantifiable risks
- ‘Specified Perils’
- Breach of contract
- Uncapped liabilities
- Performance securities

In most cases, the guidance applies equally at all tiers of the supply chain and the term ‘(sub-)contractor’ has been used to indicate this. Where there is a difference in approach between tiers, reference is made to the specific party affected.

Ultimately, by avoiding these terms, the industry can spend less time negotiating contracts, reduce the incidence of disputes, and become more sustainable in terms of productivity, innovation and profitability. In the overarching picture, it will take the industry a step towards achieving targets in the Construction Sector Deal, which includes a commitment to improve procurement, with a specific action for Government to promote the use of un-amended forms of contract on publicly funded projects.

Any feedback on the recommendation should be sent to info@BuildUK.org.

1. FITNESS FOR PURPOSE

Do not include a 'fitness for purpose' standard of care for design (except in the process sector).

i. Understanding the Term

'Fitness for purpose' is considered to be one of the highest standards of care in the industry. It is defined as any requirement whereby a company is being asked to warrant that the work, materials or services they are delivering will be suitable for, and will achieve, their intended purpose.

It is already an implied term in all construction contracts that construction workmanship and materials supplied under the contract are reasonably fit for their intended purpose, where this purpose has been made known by the client[1].

However, those responsible for drafting contracts often seek to apply this higher standard of care to design services. Fitness for purpose in relation to design elevates the standard of care above the requirement to use all reasonable skill and care of a relevant professional to one where the party taking responsibility for design becomes liable for any failure, regardless of the diligence with which they performed their duties.

[1] Section 14(3) Sale of Goods Act 1979

ii. Why it should be avoided

- Fitness for purpose creates an **unrealistic and often indefinable expectation** which can lead to dispute as to what was contractually required. It allows both parties to argue retrospectively that a particular 'purpose' was or was not implicit in the design brief. For example, should a 'multi-purpose indoor sports hall' include the capacity to serve as an ice rink in the absence of an express requirement? If the building owner decides two or three years after opening that it wants to host ice hockey and finds that the building cannot be adapted to accommodate it, is it 'fit for purpose'?
- **Professional Indemnity insurance** will typically only respond to a breach of reasonable professional skill and care. If you elevate the design standard to having to be fit for an intended purpose, you may be asking a company to agree to something that is not insurable, particularly in the current insurance market. This limits the effectiveness of including such obligations because, without insurance, many companies in the supply chain would not be able to survive the financial impact of a large claim for failing to meet the standard.
- The additional risk will invariably be priced by the supply chain and result in **higher costs**.
- A company that is exposed to fitness for purpose risk is likely to take a very **cautious approach to design**. This leads to conservative design solutions, stifling innovation, creativity and opportunities to design out costs.

iii. Implementing the Recommendation

The concept of fitness for purpose is **not limited to clauses which use that phrase**, so take care when drafting or reviewing a contract. Try to avoid using any clause imposing an absolute obligation on the company to warrant that particular (often widely defined) outcomes will be achieved. For example, it is common to see language such as 'state of the art', 'highest industry standards' or 'luxury', which are all imprecise subjective requirements. What is 'state of the art' when a major building is designed and priced can be very different by the time it is completed.

A fitness for purpose obligation can also be introduced through **performance specifications** that import specific performance criteria that must be satisfied to achieve completion, for example an energy efficiency rating for a structure (tier 1) or a settlement limit for a foundation design (tier 2).

Build UK acknowledges that the **process engineering sector applies a different risk profile for design** and so this Build UK recommendation includes an exception for this sector where fitness for purpose is quite typical and contracts such as IChemE Red Book provide for it as standard.

iv. NEC Approach

The default position in the core clauses of the ECC is a fitness for purpose obligation in respect of any design work done by a contractor. This default position can be changed through the selection of **secondary Option X15** which limits a contractor's liability for its design to reasonable skill and care.

v. JCT Approach

The default position in **clause 2.17.1** does not impose a fitness for purpose obligation. It requires that for the contractor's design of the works – as set out in the Contractor's Proposals, the Employer's Requirements and/or the Conditions – the contractor has the same design responsibility *'as would an architect or other appropriate professional designer who holds himself out as competent to take on work for such design'.*

Where the standard terms are amended or the Employer's Requirements/Contract Particulars are incomplete, there is a risk that a fitness for purpose obligation could be (inadvertently) added into the contract. To avoid this, the parties should consider adding an express statement excluding it, making it clear that in undertaking the works nothing in the contract infers a fitness for purpose obligation in relation to the contractor's design.

The default position under the sub-contract is the same as that under the main contract and is set out in **clause 2.13.1**. Sub-contracts should be clarified in the same manner as described above for main contracts.

2. UNQUANTIFIABLE RISKS

Do not include extension of time/loss and expense risk where not reasonably ascertainable for dealing with:

- Asbestos;
- Fossils, antiquities and other objects of interest or value;
- Unexploded ordnances;
- The carrying out by a Statutory Undertaker of work in pursuance of its statutory obligations in relation to the works, or the failure to carry out such work.

i. Understanding the Term

'In any construction project, there is an element of dealing with the unknown. A variety of different physical conditions, or a failure on the part of Statutory Undertakers to undertake works in accordance with the planned programme, can have a major impact on a project and in some cases stop work altogether.

It is common for these risks to be passed down to the contractor and on through the supply chain. In theory, this relieves the client of the burden but, in practice, somebody incurs the cost of dealing with the risks if they occur and it can often lead to disputes if the time and/or cost consequences exceed that which have been allowed for by the party holding the risk.

A move away from a *risk transfer* approach in favour of a *risk management* approach is recommended. Targeted investigations can help to minimise uncertainty and identify the party best equipped to manage the risk in question. For example, if asbestos is discovered in an existing building or an ancient burial ground is found while excavating the basement, this is nobody's 'fault' and it makes no sense for any party to suffer unnecessarily as a result.

ii. Why it should be avoided

- Seeking to transfer unquantified risk does not produce an adequate solution. The supply chain will include in the upfront **price** a sum of money that will be either too much or not enough, which means either the client will pay for something that did not happen or the supply chain will suffer a loss due to a circumstance outside their control.
- Making one or another party responsible for an unquantified risk **does not make the risk go away.** Whatever problem was hidden in an existing building or buried in the ground is still there and it will still cause a problem when it is found. If the problem is sufficiently large, it may have the effect of making the project unviable if the client carries the risk or causes a company in the supply chain to fail if they are deemed wholly responsible. Even if the cost and/or delay issues are not catastrophic, it can often lead to dispute if the party that suffers did not allow for them.
- A blanket approach to dealing with these risks **ignores the expertise and experience of the supply chain**. Different types of risk require different strategies; some are almost impossible to quantify whereas others can be quantified to an extent by undertaking surveys and investigations.

iii. Implementing the Recommendation

Acknowledge the likelihood of risks and leave sufficient time in the programme for adequate surveys to be carried out, in order that the risks can be properly understood and quantified where possible. Clients often undertake investigations before consulting the (sub-)contractors that are likely to have to deal with the risk(s) being investigated. This can produce information of limited value and, in some cases, disclaimers are included that prevent (sub-)contractors from relying on it in any event. Early contractor involvement can make the investigative process more cost-effective by enabling the party that is going to have to deal with the risk to specify the information it needs in order to quantify and mitigate/manage the risk and it is often more efficient to allow tendering (sub-)contractors to rely on that information. Avoid seeking to pass on risks to the supply chain where they have not had a proper opportunity to investigate and quantify such risks.

Establish a risk register at the outset of every project where risks are identified and owned by the parties best placed to deal with them. Include suitable early warning provisions in order to ensure that unforeseen events having project impacts are flagged early and actively dealt with.

In respect of asbestos; fossils, antiquities and other objects of interest or value; unexploded ordnances; and the work of Statutory Undertakers, **incorporate JCT-style contract provisions**, allowing the (sub-)contractor to recover additional time and reasonable loss and expense in the event their works are delayed by circumstances outside of their reasonable control.

iv. NEC Approach

Compensation event 61.1(12) covers for 'physical conditions which an experienced contractor would have judged at the date the contract came into existence to have such a small chance of occurring that it would have been unreasonable to have allowed for them'. This enables a contractor to recover the time cost effects of:

- Asbestos
- Unexploded ordnances occurring beyond the level that could reasonably have been expected at tender, but not the entire risk of these events occurring

Compensation event 60.1(7) covers instructions to deal with fossils, antiquities and other objects of interest or value.

Compensation event 60.1(5) covers delay and extra costs caused by the Statutory Undertaker not working in accordance with the Scope or the Accepted Programme.

A client may add additional compensation events or client's risks into an NEC contract through entries in the Contract Data. If any of these risks were identified as additional compensation events or client's risks, a contractor would be compensated for the entire time and cost effects of the event if it occurred.

v. JCT Approach

Clause 3.15 sets out the actions to be taken in the event of discovery of antiquities. **Clauses 2.26.4 and 4.21.3** permit an extension of time and recovery of loss and/or expense respectively, as a consequence of taking such actions.

The sub-contract does not include a direct equivalent to clause 3.15 in the main contract. **Clause 2.5.1** includes an obligation to comply with the main contractor's obligations under clause 3.15 of the main contract and an indemnity in favour of the main contractor should the sub-contractor fail to comply. **Clauses 2.19.5 and 4.16.3** allow for an extension of time and recovery of loss and/or expense respectively, arising out of compliance with clause 3.15 in the main contract.

Clause 2.26.7 identifies work carried out by a Statutory Undertaker as a Relevant Event, which therefore gives rise to an extension of time. There is no express entitlement for the contractor to recover loss and/or expense for such an event.

The sub-contract deals with work carried out by a Statutory Undertaker in the same manner under **clause 2.19.10**.

JCT contracts do not deal expressly with either asbestos or unexploded ordnances and there is no equivalent to NEC clause 61.1(12). Consequently, if these matters are not addressed within the Employer's Requirements (Contractor's Requirements) and/or the Contractor's Proposals (Sub-Contractor's Proposals), they will normally be at the contractor's (sub-contractor's) risk. Should the parties wish to change this risk allocation, then it will be necessary to include express terms in the contract (sub-contract) to that effect.

The right to recover time and/or cost under the unamended sub-contract is more limited than under the equivalent main contract.

3. SPECIFIED PERILS

Do not include that 'Specified Perils' (as defined in JCT) will not give rise to extension of time where caused by the (sub-)contractor.

i. Understanding the Term

The JCT suite of contracts identifies a number of events that might cause damage which are outside the coverage of indemnities provided by the (sub-) contractor and for which the (sub-)contractor is not liable. These are referred to as 'Specified Perils' and cover damage such as fire, lightning, explosions, storm, flood, escape of water, earthquake, aircraft, riot and civil commotion.

The standard position under JCT contracts is that, where completion is delayed by a 'Relevant Event', the (sub-) contractor will be entitled to a fair and reasonable extension of time. As the occurrence of a Specified Peril is included as a Relevant Event, it gives rise to an extension of time; however, it is not included as a 'Relevant Matter' which means it does not give rise to an entitlement to recover loss and/or expense.

JCT goes on to say that there is no liability for the occurrence of a Specified Peril, even if it is due to negligence, breach of statutory duty, omission or default of the (sub-)contractor[1].

This means that, in the event of the occurrence of a Specified Peril, the supply chain has no liability for delay but cannot recover their own costs of delay from the client, and the client has no liability to the supply chain but cannot recover delay damages or the like from the supply chain.

In most cases, the direct cost (repair and reinstatement of lost and damaged property) resulting from the occurrence of a Specified Peril is recoverable at all tiers through a Joint Names Policy taken out by either the client or the contractor under the main contract.

However, it has become increasingly common to include provisions that remove the (sub-) contractor's immunity from liability for delays where the occurrence of the Specified Peril was caused by them, shifting the balance of risk unevenly in favour of clients.

[1] Clause 6.3.2 JCT 2016

ii. Why it should be avoided

- Clients argue that, where a Specified Peril has arisen as a result of the negligence or default of the (sub-) contractor – for example if the (sub-)contractor has negligently burnt down the building – then it should be the responsibility of the (sub-)contractor and they should not be entitled to an extension of time. Whilst reasonable enough on the face of it, this is likely to be an **uninsurable risk**, so a (sub-)contractor would need to fund any resulting liability from its own balance sheet. In practice, this approach provides little protection for the client as the (sub-)contractor would be unlikely to be able to meet the liability (which could be substantial should the Specified Peril arise, and pursuing the loss from the (sub-)contractor could cause the (sub-)contractor to become insolvent.

iii. Implementing the Recommendation

Adopting the **standard JCT position** gives (sub-)contractors extensions of time for delays caused by Specified Perils, regardless of fault. In this way the risk is shared: the client takes the risk of its own delay-related losses, and so does the (sub-)contractor because recovery of loss and expense is generally excluded. This is similar to the 'knock for knock' principle commonly adopted in offshore oil and gas projects.

Obtain adequate **insurance** to cover Specified Perils including, if necessary, for losses arising as a result of consequential delays to the works. This could be done either by the client (for example, via an extension to the client's buildings insurance or a specific 'delay in start-up' policy) or via an extension to the Contractors' All Risks insurance policy.

Consideration could be given to a **compromise arrangement** (if the risk is to be insured by the client), where, if the Specified Peril has been caused by the negligence or default of the (sub-)contractor, then the (sub-) contractor is liable to pay any excess or deductible in the event of a claim.

iv. NEC Approach

NEC does not use the term 'Specified Perils'.

Certain events identified as Specified Perils under a JCT contract are covered as a 'prevention' event under **clause 60.1(19)** or a client's liability under **clause 81** depending on the exact cause and/or effect of the event. If an act of prevention or a client's liability occurs, it will be a compensation event entitling a contractor to additional time and money.

Any Specified Perils that are not covered by prevention or client's liabilities are a contractor's risk and so if they occur a contractor will not be entitled to any additional time but may be able to recover money under an insurance policy.

The approach in the NEC is the same for both contractors and sub-contractors, with the (NEC) subcontract identifying both contractor and client liabilities.

The client may add additional compensation events or client's risks into an NEC contract through entries in the Contract Data and this could be used to allocate the risk of further Specified Perils to a client. In this case a contractor would be entitled to claim for both the time and cost effects of the event.

v. JCT Approach

Clause 2.26.9 allows for an extension of time caused by a Specified Peril, even where it was caused by the contractor. Loss and/or expense is not recoverable.

The sub-contract deals with this in the same manner under **clause 2.19.12.**

4. BREACH OF CONTRACT

Do not include a blanket indemnity for breach of contract.

i. Understanding the Term

An indemnity is where one party agrees to make good a loss suffered by another. It provides additional protection because it makes the party giving the indemnity automatically liable if loss is incurred which falls within the scope of the indemnity, and it can operate regardless of fault.

An indemnity is not, in itself, an unreasonable requirement. Insurers 'indemnify' the insured against certain types of loss, up to a maximum value, and these indemnities are commonly offered by an insured party as part of a contract. Other types of indemnity which are generally non-contentious include tax liabilities and breach of third-party intellectual property.

However, those drafting contracts often seek to include a general indemnity for breach of contract. This creates much wider obligations and can extend a party's liability to include non-negligent damage and indirect or even consequential third-party losses which are remote and were not foreseeable. It can also have the effect of extending the period of liability beyond the typical 6 or 12-year limitation periods that apply to contractual obligations.

ii. Why it should be avoided

- A blanket indemnity exposes the party to **unforeseeable, unlimited and in some cases uncontrollable risk**. Whilst they may, on paper, have unlimited liability, they do not have unlimited resources to satisfy that liability, meaning the indemnity carries with it little or no practical benefit.
- Insurers are nervous of indemnity provisions, and wide indemnity obligations are **often uninsurable** because they are not fault-based. That said, some 'no fault' risks are insurable, such as non-negligent damage to existing structures.
- The absence of a general indemnity for breach does not leave the other party without a remedy; if the party being asked to provide the indemnity is in breach of contract, the other party will have a **remedy through adopting normal contract law principles** in any event.

iii. Implementing the Recommendation

The general industry approach is for indemnities to be reserved for **limited and specific categories** of losses which the indemnified party may incur, where the party giving the indemnity is clearly at fault and where it is most appropriate for them to 'own' that risk.

These could include:

- Tax liabilities
- Infringement of third-party intellectual property rights
- Breach of confidentiality
- Losses arising from certain regulatory/compliance breaches, for example data protection legislation

It is recommended that **blanket indemnities** for breach of contract and/or general indemnities in respect of losses 'arising out of or in the course of' the performance of the works or services are avoided. This is because the effect of these clauses will often be to render the (sub-)contractor/consultant responsible for losses outside their reasonable control, regardless of fault.

Where possible, risks that arise as a consequence of the very act of executing the project should be insured.

iv. NEC Approach

There is no blanket indemnity for a breach of contract – a contractor is only at risk for the cost and time arising out of its own liabilities as stated in **clause 81** of the contract. The client and contractor are required to pay the costs incurred by the other resulting from their own liabilities. Contractor liabilities exclude client liabilities which are identified in **clause 80** of the contract (client and contractor liabilities in the ECS).

The contract contains a separate list of events which may lead to the termination of a contractor's obligation to provide the works in **Section 9** which also details the costs payable by either party dependent on the nature of the event. There are no requirements in the contract for a contractor to indemnify a client as a result of a termination.

v. JCT Approach

There is no blanket indemnity for a breach of contract – indemnities are required for specifically itemised matters and events, most of which are insurable. Indemnity obligations are identified in **clauses 2.18 and 2.19 and section 6** of the main contract.

The sub-contract does include blanket indemnities in **clause 2.5**, in addition to indemnification for specifically itemised matters and events in **clauses 3.14 and 3.24 and section 6**.

5. UNCAPPED LIABILITIES

Do not include uncapped (sub-)contractor liability (save for certain aggregate cap carve-outs such as fraud, misrepresentation, personal injury/death, wilful default).

i. Understanding the Term

On projects of any meaningful size, the potential losses arising from breaches of contract may be such that (sub-)contractors would be unable to cover them, even with insurance. (Sub-)contractors will therefore reasonably want to limit or 'cap' their liability in order to be able to manage such risks within quantifiable parameters and protect their businesses as a going concern. On the other hand, clients will often argue that this leaves them holding at least some of the risk of a (sub-)contractor's breach.

The industry needs to move away from 'planning for failure' and work collaboratively to achieve mutually successful outcomes. Nonetheless, while performance issues remain a reality, a reasonable but sustainable level of protection for clients is required.

With respect to liability for the works, there is no point in having a £150 million liability cap for a business that turns over £100 million and makes a profit of £10 million; a meaningful but sustainable limit may be a percentage of the contract sum, not to exceed the business' anticipated profit on that project.

ii. Why it should be avoided

- **Caps on liability are generally regarded as acceptable** in today's market. Projects of significant value may carry risks which are considered to be too large for any one party to manage on the basis of uncapped liability. (Sub-)contractors and their consultants need caps to create a quantifiable 'worst case scenario' that can be managed by a combination of insurance and manageable uninsured liability. Whilst uncapped liability has the appearance of offering full protection to a client, the reality is that there is a risk that (sub-)contractors exposed to uncapped liability will simply become insolvent in the event of a major claim, potentially leaving the client with no cover at all. This is to the benefit of neither the client, nor to the longer-term health and financial stability of the industry as a whole.
- (Sub-)contractors may be able to **manage some of that risk through insurance**. However, the amount of available insurance cover is not unlimited, nor is it guaranteed that such insurance cover will always be available, particularly in the current insurance market. It can also often be the case that insurers may, for whatever reason, seek to deny cover. For this reason, (sub-)contractors and their consultants need to be able to manage their risks within the framework of an overall liability cap.
- On larger projects, **unlimited liability is not insurable** by any party at any price. It is not commercially viable for (sub-)contractors to cover unlimited liability within their anticipated project margin. It makes more sense for this risk, which is uncontrollable and unmanageable for the supply chain, to be carried by the client and mitigated by careful selection of its key supply chain members.

iii. Implementing the Recommendation

On any given project, the starting point when considering how to set the liability cap should be to consider:

- The extent of the (sub-)contractor's involvement (it is not reasonable to assume contractors and, more particularly sub-contractors, should be willing to assume high or unlimited levels of liability for what may only be a limited role);
- The losses that are likely to be incurred in the event of breach.

If those losses exceed the level of cover that can reasonably be obtained via the contractor's normal insurance arrangements, **project-specific insurance arrangements** should be considered. It may be more appropriate for a party (whether the employer or the contractor) to take out a project specific insurance policy and for the contractor's liability then to be limited to the amounts recoverable under that policy.

With respect to **liability for design**, the parties may wish to be guided by the level of financial risk represented by those design services and the amount of Professional Indemnity insurance required to cover this. Liability for design can then be limited to the insured amount.

Limitations and caps should be set at a sensible level that is sufficient to encourage the contractor to take all reasonable steps to avoid incurring the liability but not so high as to jeopardise the very existence of the business. Limiting liability to losses covered by insurance, plus a fixed sum or a percentage of the contract value for uninsured losses, is a commonly used compromise solution.

Wide carve-outs to the cap on liability, which can often have the effect of rendering any agreed cap on liability meaningless, should be avoided. It is recommended that any matters that fall outside the cap relate only to **wilful or dishonest behaviour**, or matters than cannot be capped as a matter of law, rather than unintended failures of performance.

Examples of such **'acceptable' carve-outs** to caps on liability include the following which are recognised within this Build UK recommendation:

- Fraud;
- Misrepresentation;
- Personal injury/death caused by the contractor's negligence;
- Wilful default;
- Liabilities which cannot be excluded or limited by law.

iv. NEC Approach

Selection of secondary **Option X18** provides for express caps on a contractor's liability and this can be for certain types of loss and/or all loss subject to stated carve-outs.

v. JCT Approach

There is no aggregate liability cap within the Agreement or Contract or as an option in the Contract Particulars.

Under **clause 2.17.3**, the contractor can limit his liability for consequential losses arising from his design of the works, including but not limited to loss of use and loss of profit, to an amount stated in the Contract Particulars. However, by implication, this does not limit the contractor's liability for direct costs of remediation and/or reinstatement.

Whilst there is also no aggregate liability cap within the Agreement or Sub-Contract or as an option in the Sub-Contract Particulars, **clause 2.13.3** allows the sub-contractor to benefit from any limitation under the main contract where the option under clause 2.17.3 of the main contract has been used. The sub-contractor's liability limit is the amount set out in the main contract, so the liability of the sub-contractor is proportionally higher than that of the main contractor.

6. PERFORMANCE SECURITIES

Where the following forms of performance security are required:

- **Do not use a pure on-demand performance bond**
- **Do not use a Parent Company Guarantee (PCG) which does not include a 'no greater liability' clause (save for legal costs) and equivalent rights of defence**
- **Do not use a collateral warranty which does not include a 'no greater liability' clause.**

i. Understanding the Term

Clients commonly require some form of security of performance from a (sub-)contractor to protect themselves in case the (sub-)contractor fails to perform their obligations under the contract. Primarily, these securities protect against (sub-)contractor insolvency but they also cover other performance issues that could justify the contract being terminated. Often the requirement for them is driven by parties providing funding for the project.

The securities take three basic forms:

- **Performance Bond** – provides for payment to the client for losses caused by (sub-)contractor default, up to a maximum amount, usually 10% of the contract value. There are two types of Performance Bond:
  - A 'default bond', which requires the client to prove that a default event has occurred
  - An 'on demand bond', which allows the client to demand payment on the basis of an alleged default, with no obligation to prove it
- **Parent Company Guarantee (PCG)** – provides for the 'parent' (holding) company of the party named in the contract to step in and perform the contract if that named party fails to do so. This can include physical performance of the outstanding work, payment of monetary damages for non-performance or a combination of the two.
- **Collateral Warranty** – allows third parties such as funders (or clients in the case of collateral warranties provided by sub-contractors) to enforce certain rights and obligations under the (sub-)contract in their own name, by creating a direct contractual relationship between the third party and the company providing the warranty.

All of these securities can be used to provide protection for a client, but there is a tendency for the precise wording or the trigger mechanisms to be too onerous either making them difficult for (sub-)contractors to obtain or imposing unfair risk.

ii. Why it should be avoided

Performance security is a reasonable requirement if used in the limited circumstances for which it is intended, such as insolvency or refusal to perform the work without good reason. It is not reasonable to use it to create additional requirements for the party whose performance is being secured and it should generally not be used before all the other contractual remedies have been exhausted.

- **Pure on-demand performance bonds** are not generally available from sureties; they are normally provided by the (sub-)contractor's bank. They are treated by the bank as borrowing so they have the effect of reducing working capital. This makes insolvency more, not less, likely and so on-demand bonds can actually cause the event that they are intended to protect against. As a result, a performance bond should include a requirement for default and loss to be established before the bond pays out[1].
- **PCGs** offer an alternative, and lower cost, form of security for clients where the contracting entity is part of a wider group of companies. Generally these are less contentious than bonds, although issues can still arise. Groups of companies tend to have organised themselves in that way for a reason, not least in order to ring-fence liabilities which may be incurred by particular entities from the wider organisation. PCGs have the potential to 'short-circuit' those arrangements and as such are often approached by parent company entities with caution. Parent companies will also be concerned that they might face more exposure than the primary contracting entity.
- **Collateral Warranties** should avoid increasing the obligations of the party providing them beyond what was owed under the original contract. Extending the (sub-)contractor's liability could expose it to uninsured losses if it goes beyond its Professional Indemnity insurance coverage.

[1] 'Contractors would not entertain contractual provisions which oblige them to pay to the employer at any time sums equal to 10% of the contract price against the employer's written demand whether or not the employer can reasonably establish any entitlement to such payments. Contractors therefore resist on demand bonds which operate in precisely this way and may leave them in a position where bankers debit their accounts with amounts demanded by employers even in cases where there are genuine contractual disputes.'

ABI Model Form of Guarantee Bond: An Explanatory Guide

iii. Implementing the Recommendation

Consider **whether security is required** at all. Most projects require payment to be made at monthly intervals. Assuming 14-day payment for contractors and 28-day payment for sub-contractors, at any given moment, the client has the benefit of at least the value of four to six weeks' work 'in hand' in the event of contractor insolvency or other material default; this increases to four to eight weeks at contractor/sub-contractor level. For a 10% performance bond to be more valuable than this, a contract would need to be of 10 to 12 months or more in duration.

Treat performance security as a '**menu of options'** from which the appropriate and necessary form of security is chosen based on the parties and the project in question. For example, it is rare that a client would need both a Performance Bond and a PCG. Many businesses have a corporate policy on security documents, some prefer to give bonds, others prefer to offer PCGs, and very few will provide both.

Consider whether a **PCG** is necessary, having regard to the primary contracting entity's balance sheet and insurance position. It may be the case that the party requesting the PCG is getting less protection if the overall group performs worse than the company being contracted. If a PCG is to be used, consider the following:

- Avoiding clauses which seek to make the parent a 'primary obligor' and/or make the nature of the guarantee a primary (as opposed to secondary) obligation. The parent company is there in the event of failure of the primary contracting entity, not to take the place of the entity if the client is dissatisfied;
- Including 'no greater liability' wording to the effect that the guarantor's obligations and liabilities would be no greater (in scope, nature or duration) than those of the primary contracting entity;
- Whether the entity providing the guarantee actually has the assets and/or resources necessary to give the security; sometimes the 'ultimate' parent has few assets or direct resources.

A **collateral warranty** should include 'no greater liability' and 'equivalent rights of defence' wording in order to clarify that such warranties/third party rights are secondary to, and do not provide such third party with greater or additional rights to, those available to the client under the main contract or the contractor under a sub-contract. Where a collateral warranty includes 'step-in' rights, it may also be appropriate to ensure that they are conditional on the (sub-)contractor being paid any outstanding sums that were payable prior to the 'step-in'.

iv. NEC Approach

Performance securities in NEC contracts are optional and none of these need to be selected.

Secondary Options exist for:

- A performance bond – **Option X13**
- An ultimate holding company guarantee – **Option X4**
- Undertakings to a client or others (collateral warranties) – **Option X8**.

In all cases the form of the guarantee, bond or undertaking is stated in the Scope which should be drafted to match the recommendations of Build UK.

v. JCT Approach

Performance securities in JCT contracts are optional and none of these need to be selected.

The Contract Particulars allow for the selection of:

- A performance bond
- A Parent Company Guarantee
- Undertakings to third parties by way of either Third Party Rights in **clauses 7A and 7B** of the Conditions, or Collateral Warranties under **clauses 7C and 7D**.

For a performance bond or Parent Company Guarantee, the document in which the form of the bond or guarantee is set out must be stated in the Contract Particulars. The bond or guarantee should be drafted to match the recommendations of Build UK.

The sub-contract contains no provisions in relation to either the obligation to provide or the content of a performance bond or Parent Company Guarantee.

JCT publishes the following standard forms of Collateral Warranty:

- Contractors to Funders
- Contractors to Purchasers or Tenants
- Sub-Contractors to Employers
- Sub-Contractors to Funders
- Sub-Contractors to Purchasers or Tenants.

None of these include an express 'no greater liability' clause but they do allow the contractor (sub-contractor) to rely upon 'equivalent rights in defence of liability' (if any) in the underlying contract (sub-contract), in defence of any claim made under the Collateral Warranty.

In the case of the Collateral Warranties for Purchasers or Tenants (and Sub-Contractors to Employers), there is an option in the **Warranty Particulars** to include an express limitation of aggregate liability.

USING THIS GUIDANCE

This publication is issued by Build UK Group Limited ("Build UK") in order to give general guidance only on what it considers to be best practice; if you require guidance on a specific issue, you should seek your own independent professional advice.

In accordance with competition law, the **Build UK recommendation on contract terms** is non-binding, and you must consider on an individual basis whether you wish to accept or reject all or some of the terms in your own contracts. Build UK does not and cannot enforce the implementation of this recommendation in any way.

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NEC, which contributed to the development of this guidance, can agree with the intent of the publication in a UK building specific context. However, NEC is designed for international application and across different industries where the view on risk etc. will be different. This is allowed for within the contract and the NEC's modular approach gives Clients the ability to select options/make additional Contract Data entries to reflect Build UK's recommendations where appropriate.

The information regarding JCT included within this guidance relates to the Design and Build Contracts; other forms of JCT contract may treat some of these terms differently.