

Performance Bonds

These are common in construction contracts or other concession agreements where there are performance target(s) set between the parties. In Tanzania, performance bonds are common in construction contracts, port operation agreements, production sharing agreements, mining agreements etc.

Whilst performance bonds are a standard inclusion in most projects, calling on such performance bonds may be rare but not non-existent. Prior to the performance bond being called, the employer must be sure that the damage or breach committed by the contractor cannot be remedied by the contractor.

In our experience, we have advised on the call on performance bonds by (a) a Government authority in a port operation concession. The port operator had failed to meet the performance benchmarks for several years in a row. Such breach went to the material breach of the port operation concession, so the port authority called on the performance bond put up by the port operator; (b) another occurrence was when an upstream company failed to drill the required wells within the stipulated period. The relevant Government authority attempted to call on the performance bond but it failed because the wording of the performance bond required the upstream company to consent prior to such call and the performance bond was issued by the parent company of the upstream company.

Common issues in performance bond wording/terms:

1. When and how can the employer call on it? Standard wording should allow the employer to exercise its rights to call on the bond if there is a breach of the underlying contract which cannot be remedied by the contractor. Normally there are steps to be followed by the employer prior to calling on the bond e.g. issuance of default notice to the contractor and requiring the contractor to remedy the breach within a specified time or the employer will call on the bond.
2. Time limit. Some performance bonds are issued for the duration of the project and others extend beyond the duration/term of the project. It is worth to ensure that the term stipulated in the bond assures the employer protection even after expiry of the contractual term in case any defects are later identified. However, it cannot be open indefinitely. So parties need to agree what is the reasonable duration for such bond.
3. Does the wording require the contractor to give consent/ prior approval before honoring the call on the performance bond? This is a key aspect that should be looked at by the contracting parties. This can be a restraint/stumbling block for the employer in enforcing the performance bond.
4. Is court order/arbitral award required? I.e. is it a conditional bond? The wording of the performance bond could imply that it is necessary for the court/arbitral tribunal to rule in favor of the employer that the contractor is in breach of the underlying service contract hence call on the performance bond is warranted. In some instances, the contractor could be arguing contributory acts or omissions by the employer led, caused or facilitated the contractor to be in breach of the underlying contract e.g. the contractor was supposed to reach a particular milestone within a specified time but the employer failed to get the relevant license/permit within time which prevented the contractor from commencing the works on time. Such disputes can be determined by court/arbitral tribunal and if the liability is on the contractor, then the call on the performance bond by the employer is warranted. The risk of choosing this approach by the parties is that, the dispute can lag in court for years and the losing party retains the

right to appeal to a higher court which can defeat the whole purpose of performance bond.

5. Who has issued that performance bond? Is it a financial institution/bank? Is it the parent company of the contractor? It's important to establish who the issuer is, its relationship to the contractor and its ability to satisfy the bond when called to do so. From a practice perspective, performance bonds issued by financial institutions/banks local or foreign have proved to be more reliable compared to those issued by parent companies.
6. When or what warrants the employer to call on a performance bond? This is another aspect which is crucial for any performance bond. The wording of the performance bond could include what circumstances or breaches would allow the employer to call on the bond or the underlying service contract could clearly refer to the circumstances warranting the call on a performance bond. Here both parties should make sure that each of their interests are protected.
7. Is there a limitation on liability which can be satisfied by calling a performance bond? Some performance bonds stipulate the maximum amount of liability payable, other performance bonds limit the liability payable to 10 or 20% of the underlying value of a contract etc. The parties should look into the wording closely to ensure that the amount payable is not too low for the employer and not too exorbitant for the contractor.
8. Governing law and dispute resolution clause should be included in the performance bond agreement. Unfortunately, disputes can arise from the implementation or enforcement of performance bond and the parties need to be clear which law and which dispute mechanism shall be adopted by the parties in case of such a dispute. It goes without saying that, if the performance bond has a time limitation, the time should be frozen throughout the time the dispute over its enforcement is before court/arbitral tribunal.

How does Go2Experts assist in such transactions?

We have been involved in reviewing construction agreements including those under FIDIC. Also, we have advised on EPC contracts and financing of such projects. We can assist on such projects from a legal perspective i.e. review of contracts, dispute resolution both court and arbitral proceedings, permits and licenses required in implementation of such projects etc.

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