CONSTRUCTION INDUSTRY COUNCIL 建造業議會

FOR IMMEDIATE RELEASE

Construction Industry Council Publishes *Procurement Alert No. 001/14 – Use of On-Demand Performance Bonds in Construction Contracts*

Hong Kong • 15 September 2014 – The Construction Industry Council (CIC) today released a new publication entitled *Procurement Alert No. 001/14 – Use of On-Demand Performance Bonds in Construction Contracts* (Procurement Alert). This Procurement Alert aims to serve as a reminder to all industry stakeholders that they must act in a responsible manner when asking for on-demand performance bonds in construction contracts.

Introduction

An on-demand or unconditional performance bond is a type of financial tool that is sometimes used by employers in the construction industry as additional financial security held against contractors (or in the case of contractors, against sub-contractors) to guarantee performance of the contract.

When deciding whether to adopt an on-demand performance bond for a construction contract, the procurement alert recommends the employer to evaluate carefully the necessity of requiring an on-demand performance bond; consider the risk profile of the project and the suite of alternative risk management tools available; and adopt a pro-active approach to promoting good performance.

If an on-demand performance bond is required in construction contract, the procurement alert recommends the following: the wording of the bond should be clear and unambiguous; due consideration should be given to determine an adequate bond amount; an appropriate expiry date should be in place; the bond should be kept in a safe place; extending the validity period of the bond beyond the date of practical completion or the end of the defects liability period should be avoided; and contract provisions should be included to help alleviate concerns of abuse.

Publication

The use of on-demand performance bonds will add to the ultimate cost of a project and may deter some contractors from tendering for the project, particularly in a booming construction market. The CIC urges all industry stakeholders to consider the measures recommended in this Procurement Alert, think carefully before they decide to adopt an on-demand performance bond for a construction contract, and act in a responsible manner when asking for on-demand performance bonds.

The Procurement Alert is available for download on the CIC website www.hkcic.org.

About the Construction Industry Council

The Construction Industry Council (CIC) was formed on 1 February 2007 under the *Construction Industry Council Ordinance* (Cap. 587). The CIC consists of a chairman and 24 members representing various sectors of the industry including employers, professionals, academics, contractors, workers, independent persons and government officials.

The main functions of the CIC are to forge consensus on long-term strategic issues, convey the industry's needs and aspirations to government, provide training and registration for the construction workforce and serve as a communication channel for government to solicit advice on all construction-related matters.

To learn more about the CIC, please visit www.hkcic.org for further details.

Media Enquiries

Ms. Esther LAI / Ms. Patricia CHIU
Corporate Communications & Marketing Department
Tel: (852) 2100 9038 / 9044
Fax: (852) 2100 9090
Email: corpcomm@hkcic.org

~ End ~

(The Procurement Alert can be found on P.3 to P.5)

Use of On-Demand Performance Bonds in Construction Contracts

Procurement Alert No. 001/14

An on-demand or unconditional performance bond is a type of financial tool that is sometimes used by employers in the construction industry as additional financial security held against contractors (or in the case of contractors, against sub-contractors) to guarantee performance of the contract. It imposes an obligation on the issuer, usually a bank or an insurer, to pay the employer when the employer sends the issuer a written demand stated to be on the basis of the event specified in the bond, without the need to prove that the contractor is in default or the amount of loss the employer has suffered.

Whilst some employers consider the use of on-demand performance bonds as part and parcel of risk management for a project, some contractors' and sub-contractors' organisations have raised concerns about the use of such bonds. The main concerns of the contractors are the resulting capital and bank facility lock-up and the potential abuse by the beneficiary of its right to call an on-demand performance bond.

This Alert serves as a reminder to all industry stakeholders that they must act in a responsible manner when asking for on-demand performance bonds in construction contracts.

The use of on-demand performance bonds will add to the ultimate cost of a project and may deter some contractors from tendering for the project, particularly in a booming construction market.

Some banks may treat the on-demand performance bond as part of the contractor's credit line. Procurement of an on-demand performance bond may therefore lower the total contract value that a contractor can take on, hence reducing the contractor's financial ability to tender for new construction works. As such, the number of contractors available for tendering in the market may be reduced.

Address: 15/F, Allied Kajima Building
138 Gloucester Road, Wanchai, Hong Kong
Tel: (852) 2100 9000
Fax: (852) 2100 9090
Email: enquiry@hkcic.org

No. PA-PNS-001-14-E
September 2014

When deciding whether to adopt an on-demand performance bond for a construction contract, it is recommended that:

- The employer should evaluate carefully the necessity of requiring an on-demand performance bond, taking into consideration the risk profile of the project and the suite of alternative risk management tools available.
- The alternative risk management tools which may be available include default bonds, personal or parent company guarantees and increased retention amount as well as stringent financial checks on tenderers beforehand.
- A pro-active approach to promoting good performance through diligent management, equitable risk sharing, a realistic construction programme and the selection of a contractor/sub-contractor with a good reputation, a sound financial history and a realistic competitive price should also be considered as an alternative to requiring an on-demand performance bond.

If an on-demand performance bond is required in construction contract, it is recommended that:

- The employer should ensure that the wording of the bond is clear and unambiguous.
- Due consideration should be given to determining an adequate bond amount that is proportionate to the complexity, size and value of the project and the level of risk involved, while providing adequate protection for the beneficiary. Where the contract provides for sectional completion consideration should also be given to reducing the amount of the bond on the completion of each section.
- An on-demand performance bond should have an appropriate expiry date such as the date of the occupation permit or substantial or practical completion.

Address: 15/F, Allied Kajima Building
138 Gloucester Road, Wanchai, Hong Kong
Tel: (852) 2100 9000
Fax: (852) 2100 9090
Email: enquiry@hkcic.org

No. PA-PNS-001-14-E
September 2014

- It is a good practice to keep the bond in a safe place. Some banks may require the return of the original bond once its purpose has been served. Thus, safe keeping of the bond also facilitates easy and prompt retrieval of the bond for returning to the contractor and then to the issuer.
- Extending the validity period of the bond beyond the date of practical completion or even the end of the defects liability period should be avoided. Where such practice is adopted, consideration should be given to the possibility of providing for the reduction of the bond amount upon issuance of the certificate of practical or substantial completion of the works.
- Consideration should be given to the inclusion of contract provisions that may help alleviate concerns of abuse, such as a requirement for the architect or engineer to submit to the bond issuer some form of certification or written statement stating that the contractor is in material breach of his obligations under the contract (or in breach of a defined term) as a pre-condition to payment under the bond by the issuer.

Address: 15/F, Allied Kajima Building
138 Gloucester Road, Wanchai, Hong Kong
Tel: (852) 2100 9000
Fax: (852) 2100 9090
Email: enquiry@hkcic.org

No. PA-PNS-001-14-E
September 2014