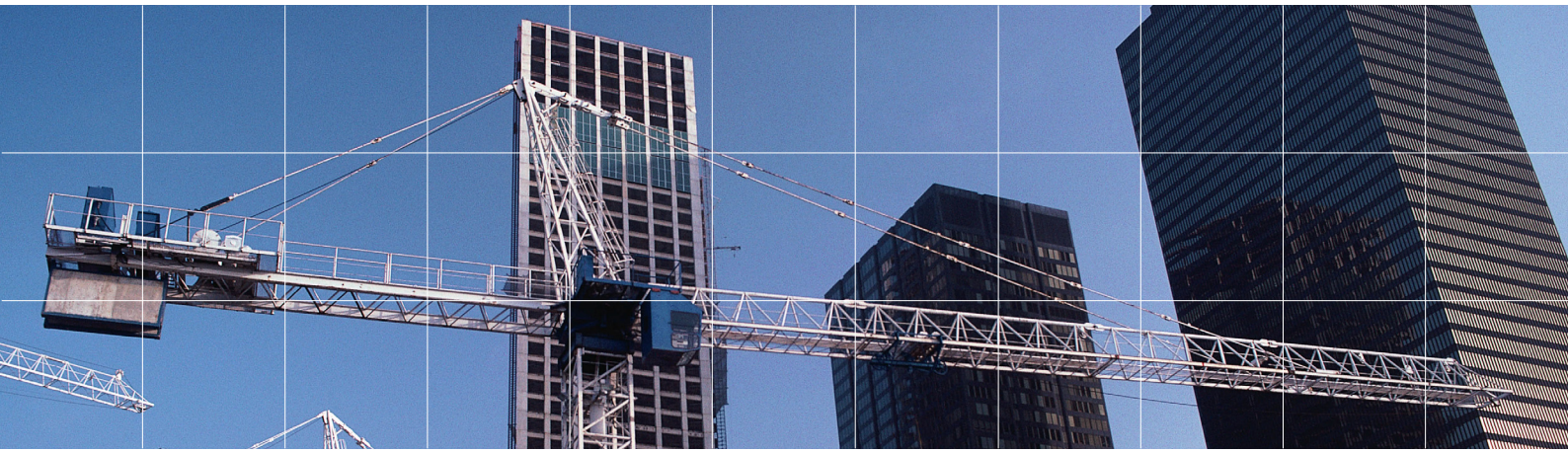
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GUARANTEES & BONDS IN THE CONSTRUCTION INDUSTRY

■ **CASE NOTE:** ***WELTIME HONG KONG LTD V COSMIC INSURANCE CORP LTD***

ABSTRACT

Insolvency is a particularly real risk within the construction industry. For this reason, employers typically require main contractors to furnish performance bonds to secure their performance during the construction and maintenance periods. In the case of a conditional bond, as the employer must prove that it had incurred damages occasioned by main contractor's default(s) to call on the bond, employers typically do so only after they obtain an award against the main contractor. The recent case of *Weltime Hong Kong Ltd v Cosmic Insurance Corp Ltd* [2004] 2 HKC 155, however, demonstrated that, in the absence of "special agreement", the employer cannot rely on an award against its main contractor as evidence to enforce a conditional bond against the financial institution.

Although this case sends a clear message to employers that they assume the risk of careless drafting in performance bonds for their benefit, the underlying principle cuts both ways. The main contractor who relies on a parent guarantee from a big-name listed developer to do business with its two-dollar company subsidiary likewise faces the same consequences should the guarantee fail to cover its award against the subsidiary. For those who presently hold conditional bonds that do not contain any "special agreement" or arbitration clause, in the event of a dispute with the developer or the main contractor, they should evaluate whether it would be in their best interests to first institute court proceedings against the financial institution rather than proceed against the main contractor in arbitration.

INTRODUCTION

Most employers recognize that the risk of insolvency is particularly elevated within the construction industry and that safeguards are required to protect them from the consequences of the main contractors' insolvency. This is why, in construction contracts of any kind, there are almost invariably provisions requiring the main contractor to furnish a performance bond (usually for a percentage of the tender price) by an approved financial institution within a certain period of time of the award of the contract to secure its performance during the construction and maintenance periods.

A performance bond in the construction context is essentially a deed whereby the financial institution promises to pay the employer a cash sum in the event of default by the main contractor. The two types of performance bonds commonly used in the Hong Kong construction industry are the "conditional" and "on-demand" bonds. The difference between the two lies in the evidential requirements which have to be satisfied before the financial institution is obliged to make payment to the employer.

If the performance bond is an on-demand bond, the employer is not required to prove that the contractor is in breach of its obligations under the construction contract. Typically, all the employer has to do to call on the bond is to:

- state that there has been default by the main contractor under the construction contract;
- prepare in good faith a statement of damages arising from the main contractor's default(s); and
- comply with any formalities or procedures specified in the bond for the call on the bond.

In contrast, in the case of a conditional bond, the employer must prove that it had sustained damages occasioned by main contractor's default(s) (see the English House of Lords' decision in *Trafalgar House Construction (Regions) Limited v General Surety and Guarantee Company Limited* [1995] 3 All ER 737). If the employer succeeds, it can make a call upon the bond up to the amount of the damages proved in accordance with any formalities or procedures specified in the bond.

Due to its evidential requirements, employers often call on a conditional bond only after obtaining an arbitral award against the main contractor. Many employers are, however, unaware that the financial institution is actually not bound to regard an award against the main contractor as proof of the main contractor's default(s) unless otherwise stated in the bond itself. The recent decision of the Court of the First Instance of the High Court of Hong Kong in *Weltime Hong Kong Ltd v Cosmic Insurance Corp Ltd* [2004] 2 HKC 155 confirmed that, in the absence of agreement, the employer cannot rely on an award against its main contractor as evidence of the findings of fact or the conclusions of causation to enforce a conditional bond against the financial institution. An employer may therefore be faced with the unhappy prospect of having to retry its claim(s) against the financial institution in court should the financial institution choose to resist its call on the conditional bond, even though the employer already has an award against the main contractor.

It should be noted that the above is not a new concept or "risk" facing employers or contractors. It was highlighted as long ago as 1881, when the English case of *Re Kitchin* (1881) 17 ChD 668 decided that unless the guarantor has explicitly agreed otherwise, a judgment or award obtained by the creditor against the debtor does not bind and is not evidence against the guarantor and the creditor must prove the debtor's liability against him.

The case of *Weltime v Cosmic Insurance*, however, is a timely reminder to the Hong Kong construction industry that both employers and contractors should draft the terms of their performance bond carefully.

THE CASE: *WELTIME HONG KONG LTD V COSMIC INSURANCE CORPORATION LTD*

The Facts. In *Weltime v Cosmic Insurance*, a property developer, had engaged a main contractor for its residential development in the New Territories, Hong Kong. As required under the contract, the main contractor procured a conditional bond for HK$29,900,000.00 from an insurer, in favor of the developer to guarantee the main contractor's contractual obligations.

Disputes arose between the developer and the main contractor during the execution of the works. These disputes were duly referred to arbitration in accordance with an arbitration clause under the contract, and in due course, the arbitrator awarded the developer damages in the

amount of HK$17,102,218.97 for the main contractor's defaults in its performance of the contract.

The main contractor failed to honor the award. The developer, as expected, then proceeded to serve on the insurer a demand for payment under the conditional bond. The insurer asserted that it had been unaware of the arbitration proceedings and the award until the demand was served on it and refused to pay the developer.

The developer then commenced court proceedings against the insurer and applied for summary judgment for the sums due. The developer contended that the arbitral award constituted conclusive evidence of the main contractor's defaults and of the developer's consequential loss and damage for which the insurer was liable as surety.

The Decision. The court dismissed the developer's application on the basis of its finding that the arbitral award had no evidential value in the developer's proceedings against the insurer. The court held that:

> *"The [developer] needs to establish against the [insurer] afresh at the trial of this action the defaults on the part of [the main contractor] and the loss and damage that it had suffered as a result."*

The grounds for the court's decision are as follows:

There is a well-established common law principle that in the absence of "special agreement", the general words in a conditional bond guaranteeing the due performance of all the obligations of the main contractor do not mean that the financial institution is bound by an award between the employer and the main contractor.

This principle applies even in cases where the award arises out of an arbitration clause in the contract containing the obligations guaranteed by the financial institution.

Serious injustice could occur if the financial institution were bound by the award of an arbitration to which it was not a party, for example, where:

- the main contractor fails to argue or plead relevant points which would disentitled the employer to some or all of the amounts awarded; or
- the main contractor makes admissions in the course of the arbitration without the financial institution's approval; and
- The mere fact that insurer knew at the time it granted the conditional bond that any disputes between the developer and the main contractor would be conclusively resolved by arbitration did not amount to a "special agreement", on the part of the insurer that it accepted the award as conclusive evidence binding on it when the developer sought to enforce the conditional bond in some other proceedings.

DISCUSSION

There is sound basis for the court's decision in *Weltime v Cosmic Insurance*. First, because an arbitrator is appointed by the parties and because his authority derives from the arbitration agreement, it follows that the legal effects of his award are restricted to the relationship *inter partes*. Moreover, there is a legitimate concern that serious injustice may occur if third parties which have not had an opportunity to participate in the arbitration proceedings and be heard are held to be bound by the arbitral award.

In practical terms, however, there is no doubt that following this decision, employers in Hong Kong who rely on conditional bonds only as a last resort when they are unsuccessful in enforcing awards against their main contractors, may run the risk, in the absence of some "special agreement", of re-litigating the entire dispute in court. Worse, there is no assurance that the same favorable findings made in the arbitration would similarly be made in court.

One may speculate whether the decision would have been different if the insurer had been informed about the arbitration, and even attended the hearing. In the case of an award against a two-dollar subsidiary, would there be a "special agreement" imputed if the directors of the big-name developer are also directors of the two-dollar subsidiary and/or are running the project in question? These questions remain untested by the courts.

Whilst the court did not specifically define what would constitute a "special agreement" to bind a financial institution to the arbitral award of an arbitration between the employer and the main contractor, one can reasonably infer from two aspects of the decision that nothing less than a clearly

worded provision in the conditional bond or a separate undertaking by the financial institution in clear terms would ensure that this risk is avoided:

- the court's reliance on the English Court of Appeal's decision in *Re Kitchin* (1881) 17 ChD 668 where James LJ held:
  "*... It is contended that* [the surety] *is liable to pay any sum which an arbitrator shall say is the amount of the damages. The guarantee must be expressed in very clear words indeed before I could assent to a construction which might lead to the grossest injustice...*" (emphasis added); and
- the court's finding that there was no "special agreement" on the facts based on a review of the terms of the bond in question and the extrinsic evidence adduced.

The Aftermath. To avoid the risk of duplicate proceedings, employers should consider inserting a provision to stipulate:

- that the financial institution will honor an award of an arbitration between the employer and the main contractor even though it is not a party to that arbitration; or failing agreement to this provision,
- that any dispute which may arise between the financial institution and the employer in connection with the bond is to be referred to arbitration.

The earlier provision may enhance the prospect of making the arbitral award conclusive evidence of the main contractor's defaults and of the employer's consequential loss and damage as against the financial institution, whilst the latter provision (a distant second choice and only if the first option is rejected) may enable the employer to simultaneously commence arbitration proceedings against both the financial institution and the main contractor with a view to applying (where possible) for a joinder of proceedings, or at least seeking to appoint the same arbitrator in respect of both proceedings.

For those employers currently holding conditional bonds which do not contain any "special agreement" or arbitration clause, in the event of a dispute with the main contractor, the best chance of recovering compensation for the main contractor's default(s) may well be to first commence court proceedings against the financial institution directly. This would especially make sense if its estimated claim amount is less than or equal to the bond amount or if the main contractor is insolvent.

FURTHER INFORMATION

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