

RICS Professional Guidance, UK

Construction security and performance documents

1st edition, guidance note



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RICS guidance note

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Acknowledgment

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RICS produces a range of professional guidance products. These have been defined in the table below. This document is a guidance note.

Type of document	Definition	Status
Standard		
International Standard	An international high level principle based standard developed in collaboration with other relevant bodies	Mandatory
Practice Statement		
RICS practice statement	Document that provides members with mandatory requirements under Rule 4 of the Rules of Conduct for members	Mandatory
Guidance		
RICS Code of Practice	Document approved by RICS, and endorsed by another professional body/stakeholder that provides users with recommendations for accepted good practice as followed by conscientious practitioners	Mandatory or recommended good practice (will be confirmed in the document itself)
RICS Guidance Note (GN)	Document that provides users with recommendations for accepted good practice as followed by competent and conscientious practitioners	Recommended good practice
RICS Information Paper (IP)	Practice based information that provides users with the latest information and/or research	Information and/or explanatory commentary

Introduction

This guidance note reviews security and performance documents normally associated with a construction project. In general terms, these are documents required as security for performance of one sort or another (whether payment, design, management or construction) in a project. In complex projects, there may be many different types of security and performance documents required by several parties.

This guidance note will review the main types of security and performance documents, the parties to them, their purpose and general terms. It begins with a discussion of the general principles (Level 1 – Knowing), is followed by a review in more detail of the nature and purpose of construction security and performance documents (Level 2 – Doing) and ends with a consideration of practical matters that can arise (Level 3 – Doing/ Advising).

1 General principles (Level 1 – Knowing)

1.1 Introduction

1.1.1 Many construction projects, no matter what their size, have a potentially complex structure of contractual relations and multiple parties. The payment paths can be wide-ranging – from employers to contractors and from contractors down the supply chain to sub-contractors and suppliers. Cash flow is the life blood of the construction industry and keeping payments flowing is essential. The performance of payment obligations on all sides is, therefore, of fundamental importance and involves a consideration of how such performance can best be secured and risks of non-payment minimised as far as possible.

1.1.2 The employer may enter into development and funding obligations with third parties, such as funders, purchasers and tenants. Many employers receive funding from different sources, such as banks and building societies. These funders will require ‘construction security’ documents to be in place to help protect their loans and before they will release funds. The project may be let or sold (before, during or after construction) to purchasers and tenants. When taking an interest in a new, recently built or recently refurbished property, such purchasers and tenants will also want construction security. Funders, purchasers and tenants are likely to require a contractual connection with those responsible for the design and construction of the project in order to protect their position. This would be necessary, for example, in the event of defects manifesting themselves at a later date after occupation or acquisition by tenants or purchasers, or if funders wish to step into the position of the employer if the employer becomes insolvent or otherwise defaults. In the absence of such a contractual connection, it is unlikely that these third parties would be able successfully to claim against parties responsible for the defect or, in the

case of a funder, to step into the position of the employer in order to complete the project.

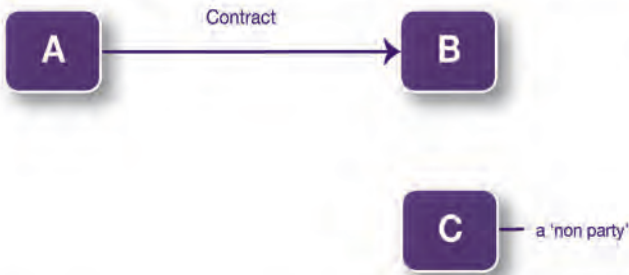
1.1.3 A contractual connection is required because a basic rule of contract law is the doctrine of ‘privity of contract’. This doctrine provides, as a general principle, that only a party to a contract can take the benefit of that contract. Many parties are involved in the design, management and construction process and an employer will almost always enter into formal, written contracts with the members of its design and management team and the contractor employed to carry out the works. These contracts will deal with the services and works the team and the contractor are required to carry out, how they are paid and so on. Third parties (such as funders, purchasers and tenants) do not enter into these contracts (indeed some of these third parties may not even be identified at the time such contracts are entered into). However, if a consultant or contractor makes a mistake during design or construction, and a defect in the completed building arises as a result, a funder, purchaser or tenant might suffer financial loss (e.g. the cost of rectifying the defect, the cost of finding alternative accommodation while the defect is rectified, loss of interest and rental income, etc.).

In general terms, the doctrine of privity of contract means that, in the absence of any contract with those responsible for a mistake, the funder, purchaser or tenant, would not be able successfully to claim in contract to recover such loss. Further, as the law currently stands, it would be very difficult (if not impossible) for a funder, purchaser or tenant to recover their losses from the consultants and contractor on a ‘non-contractual’ basis, such as under the law of tort (essentially negligence).

Figure 1(a) illustrates the doctrine of privity of contract.

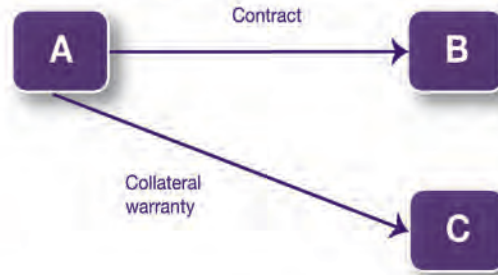
Figure 1 – (a) Doctrine of privity of contract, (b) Collateral warranties and (c) Third party rights

Figure 1(a) – Doctrine of privity of contract



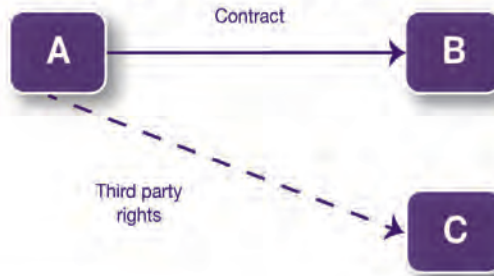
B can enforce A's contractual promises and obligations as if is a party to the contract. C is not party to the contract so cannot take any benefit of it (and nor can C have any burden under it).

Figure 1(b) – Collateral warranty



B can enforce A's contractual promises and obligations. C receives a collateral warranty under which A warrants to C that A has complied, or is complying, with the terms of its contract with B. C can, therefore, enforce the terms of the collateral warranty against A.

Figure 1(c) – Third party rights



B can enforce A's contractual promises and obligations. C receives 'third party rights' as the contract between A and B expressly provides that C may enforce a term or terms of the contract between A and B or purports to confer such a benefit on C. C can enforce such third party rights even though C is not a party to the contract between A and B and does not have a collateral warranty with A.

1.1.4 A collateral warranty (sometimes also called 'a duty of care deed') has been, and remains, one of the ways of overcoming these difficulties. A collateral warranty is a binding contract between a third party with an interest in the project under construction or in the completed project (such as a funder, purchaser or tenant) and a party who was involved in the design, management and/or construction of the project. A collateral warranty would allow a third party to make a claim against, for example, a structural engineer, if the engineer's design fell below a required standard of skill and care and/or a contractor, if the building was built defectively. In order for any claim to be successful under a collateral warranty, as in any contractual claim, the third party would have to show that it suffered loss as a result of the defective design and/or workmanship.

Figure 1(b) shows, in simple terms, the use of a collateral warranty.

1.1.5 The general rule under the doctrine of privity has been fundamentally changed by the *Contracts (Rights of Third Parties) Act 1999* (the TPR Act). In short, the TPR Act provides that a

third party (such as a funder, purchaser or tenant) may in its own right enforce a term, or terms, of a contract if such contract expressly provides that it may do so or purports to confer such a benefit on it. In this manner, such third party rights allow a third party to make a claim against any consultant or contractor for defective design and/or workmanship in much the same way as under a collateral warranty. In the example set out in paragraph 1.1.4, the third party would be able to make a claim against the structural engineer and/or the contractor, even in the absence of a collateral warranty, provided that the structural engineer's appointment and building contract effectively provided that the third party could, in its own right, enforce the terms of such appointment and contract. In other words, the third party can, in those circumstances, take the benefit of the terms of a contract even in the absence of a direct contractual link (the TPR Act thereby creating an exception to the privity of contract doctrine). Figure 1(c) illustrates the use of third party rights. While third party rights are being increasingly adopted in UK development projects, collateral warranties are still widely

used. This balance, however, is changing as the construction industry becomes more familiar, and comfortable, with third party rights.

1.2 Parties to a project

A development project often comprises the following parties:

- funders
- employers/developers
- professional consultants, such as architects, engineers (structural and mechanical and electrical), quantity surveyors, cost consultants, CDM co-ordinators and project managers.
Sometimes this team will be augmented by specialist consultants, such as acoustic consultants and sustainability consultants
- contractors; and
- sub-contractors.

1.2.1 Funders

(a) Funders are parties who lend money in connection with a project, usually banks, building societies or other similar funding institutions. However, certain institutional investors, such as pension funds or life assurance companies, fund projects and are typically referred to as 'funds'. An employer (likely to be referred to as a developer) and a fund of this nature may exchange contracts for the sale of the completed property at an early stage of the development process (such as when the works are partially complete or even before they have started), a so-called 'forward purchase'. The fund does not agree to provide construction finance but will pay the purchase price when the project is completed. In contrast, certain funds may (in what is known as a 'forward funding' arrangement) provide finance to the employer to cover the cost of the project as it progresses during the development phases (including the costs of the contractor and the consultants). In such an arrangement, the fund is likely to purchase the land at the outset, before development commences. For the purposes of this guidance note, funders are parties (such as banks and

building societies) who lend money in the more traditional bank lending sense, although the funds in forward purchase and forward funding transactions may also require construction security documents similar in nature to those required by funders.

(b) Funders will want to be comfortable that their involvement will be satisfactory from a financial point of view but also that, if matters do not go according to plan, they are as well protected as possible.

(c) There is likely to be a lengthy facility, or funding, agreement between the funder and the employer (the borrower). The funder will be concerned to cover the position where the employer gets into financial difficulties. The risk of contractor, principal sub-contractor or consultant insolvency is normally left with the employer.

(d) If there is an employer default (financial or otherwise), a funder will wish to have arrangements in place from the outset that enable it to take over the project itself, or through an appointed third party with comparable skills to the employer, in order to complete it (sometimes referred to as 'building it out'). This is to achieve completion of the project with the minimum of extra expense, disruption and delay that will inevitably occur in these circumstances.

1.2.2 Employers

(a) The employer is the party for whose benefit the project is carried out. An employer is often referred to as a client, developer or promoter, depending on the context.

(b) The employer will (with relevant members of its team) appoint the consultants, choose the contractors, agree the terms of the building contract (including the contract sum) and then arrange for these parties to be paid.

(c) The employer is particularly interested to ensure that the project succeeds – that costs come within budget and that the project meets expectations relating to quality, health and safety and programme. The employer may want to let and/or sell the completed project (in whole or in part) and it may have borrowed money from funders to pay for the works. The

employer will want to ensure that all third party security and performance documents are in place (or can be put into place) so that the conditions of any letting, sale and funding are satisfied. It will also want to ensure that its position is protected in the event of any serious default by anyone in the contractual supply chain, particularly the main contractor.

1.2.3 Professional consultants

(a) The primary roles of the professional consultants engaged by the employer are to design, cost, manage and administer the contracts and the project. They also carry out services relevant to statutory responsibilities, such as obtaining planning consents for the employer and ensuring compliance with health and safety regulations.

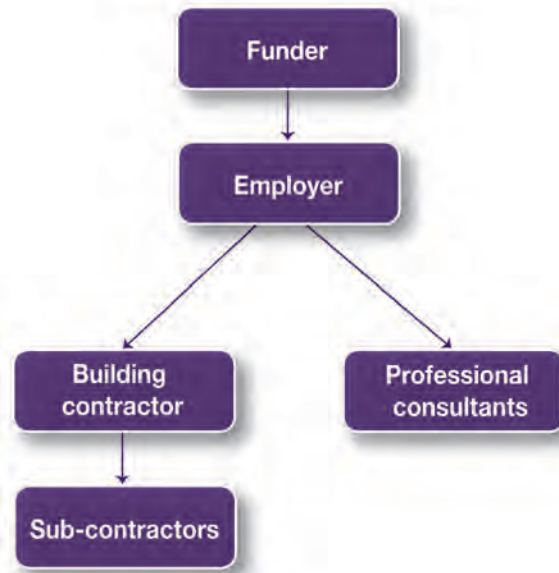
(b) The employer may be entering into formal, written appointments with each of the consultants. These appointments are likely to be based on those published by the relevant body governing the profession of the consultant (such as RICS, RIBA and ACE) or to be in a bespoke form, i.e. drafted by or on behalf of the employer and tailored for the particular requirements of the project. These appointments will usually include, for example, an obligation upon the consultant to provide collateral warranties and/or third party rights to third parties, such as funders, purchasers and tenants. In some projects, funders will separately appoint independent technical monitors to deal with payments and to check that the project is being carried out properly and not over-running in terms of cost and time. These monitors will generally be professional consultants who will work alongside the consultants appointed by the employer.

1.2.4 Contractors

(a) The contractor agrees to carry out the building works in accordance with the drawings and/or specifications and the terms of the building contract agreed with the employer. They may do so themselves or (more usually) employ sub-contractors to carry out some or all of the works. The contractor will be responsible for managing and monitoring the sub-contractors and (as a general rule) for their performance.

(b) The contractor may agree to construct the works in accordance with the design produced by the employer and/or their professional consultants – the so-called ‘traditional’ method of procurement. This is illustrated by Figure 2.

Figure 2 – ‘Traditional’ procurement



(c) Alternatively, the contractor may agree to take on design responsibility under the building contract – the so-called ‘design and build’ method of procurement. This is illustrated by Figure 3.

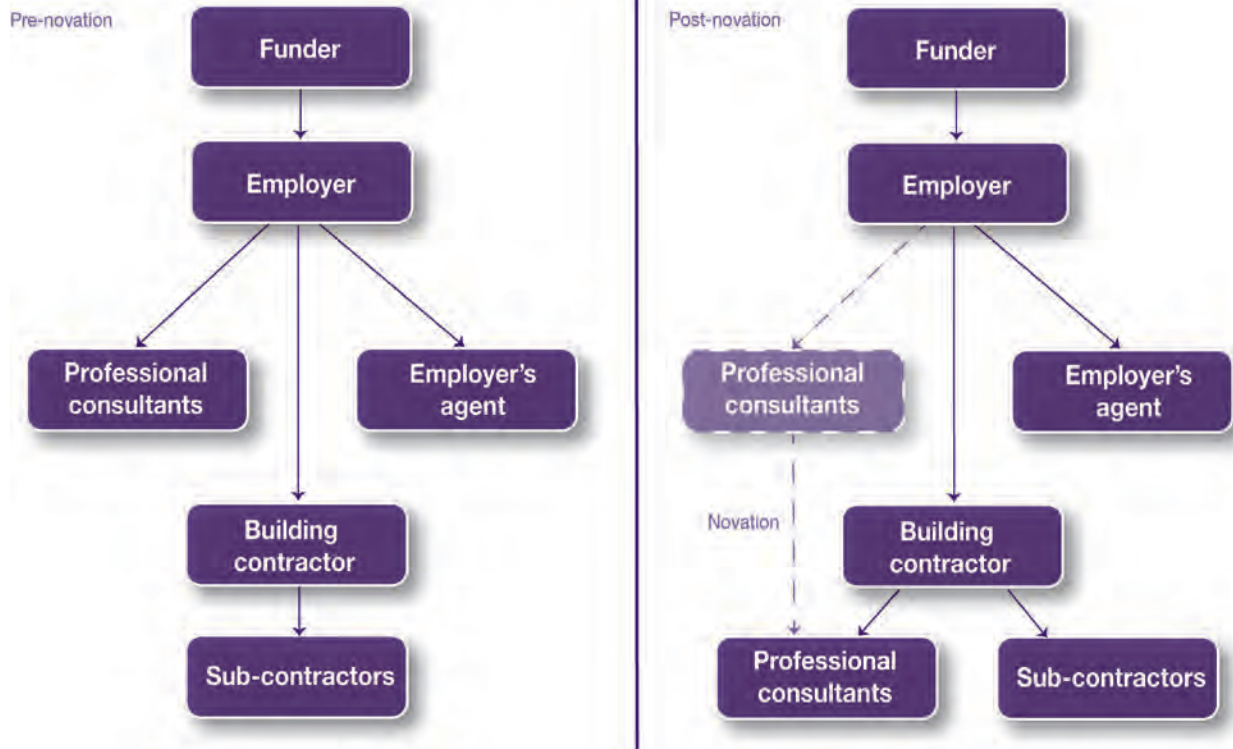
(d) There are other procurement methods but this guidance note concentrates on the types more frequently used. The general principles, however, can be carried through where other methods of procurement are adopted.

(e) The employer will most likely enter into a formal, written building contract with the contractor which reflects the chosen method of procurement. The contract may (as with the consultants’ appointments) be in a standard form, such as those published by the JCT or NEC, or may be bespoke (probably an amended standard form) to reflect the requirements of the project.

1.2.5 Sub-contractors

(a) Main contractors will generally employ sub-contractors to undertake some or all of the design and/or construction of the works. The main contractor will usually take responsibility for the works of their sub-contractors as if they

Figure 3 – 'Design & Build' procurement



had carried out the works themselves, but the employer and third parties (such as funders, purchasers and tenants) will most probably look for performance security from the main design sub-contractors in the event that the main contractor defaults or becomes insolvent.

(b) The sub-contractors may enter into formal, written sub-contracts with the main contractor. These may be in a standard form (such as the JCT and NEC forms) or an amended standard form. The sub-contract will usually be a 'flow down' of the relevant obligations placed upon the main contractor. For example, if the main contractor has to obtain collateral warranties or third party rights from certain sub-contractors in favour of third parties, this obligation should be passed down by the main contractor to those sub-contractors by way of inclusion in the relevant sub-contracts.

(c) There may be specialist suppliers who are contracted to supply goods and materials to the contractor and/or sub-contractors, such as ductwork and cladding suppliers. It would be unusual to have collateral warranties or third party rights from such suppliers as

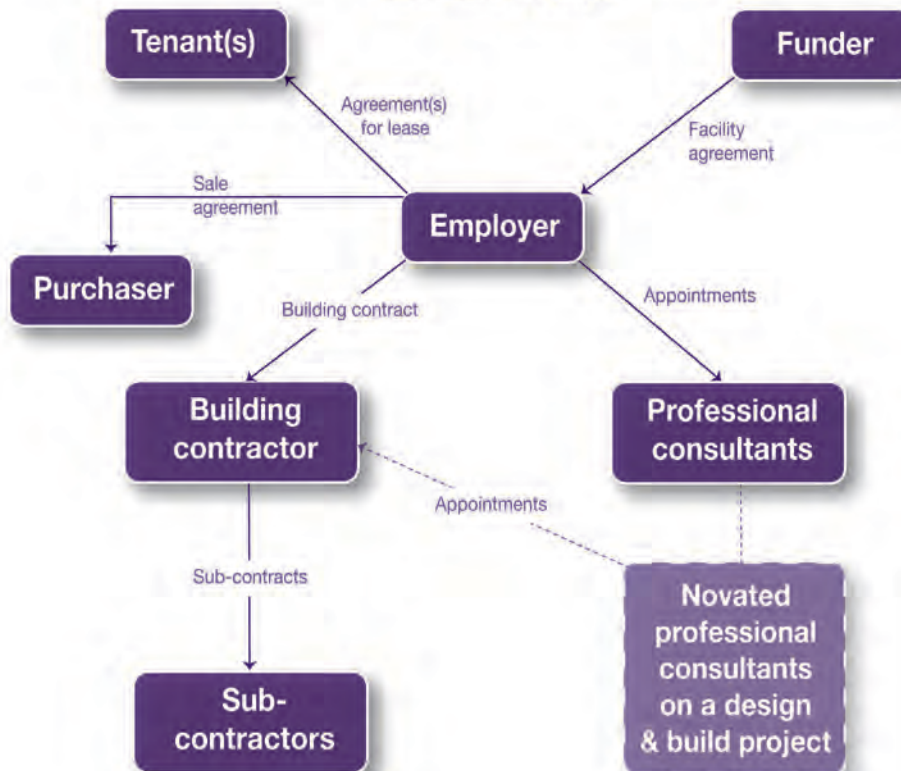
responsibility for their goods and materials is usually assumed by the contractor or sub-contractor incorporating them into their works. There may, however, be product guarantees and warranties relating to the quality of such goods and materials given by the supplier, which are available to the owner of the completed project. Such product guarantees and warranties are not discussed in this guidance note.

1.3 Interested third parties

An employer will often finance the project with outside funds. An employer may wish to develop the project for their own use or with a view to selling and/or letting it (or parts of it). Such funders, purchasers and tenants all have an interest in the outcome of the project. For the purposes of this guidance note, they will generally be referred to as 'interested third parties' or 'interested third party beneficiaries'.

Figure 4 illustrates the inter-relationship between various interested third parties on

Figure 4 – Interrelationship between interested third parties on a project



traditional and design and build procurement methods in a typical project.

1.4 Construction security and performance documents

1.4.1 General

(a) When taking an interest in a construction project, interested third parties usually require some form of construction security. This security may be available over, or alongside, the rights to enforce some of the terms of the contracts between the employer and those who are designing, managing and/or constructing the project. It may allow a party with an interest in the project to exercise rights that they would not otherwise have. For example, it is specifically in relation to the area of employer default that potential problems arise for a funder in funding a project. In order to safeguard the investment a funder has made, the funder will want to have in place arrangements that enable them, in the event of serious default by an employer, to take over the whole project themselves, or possibly through

an appropriately qualified third party appointed by the funder. This is to ensure that they can build out and secure completion of the project with the minimum of disruption and delay (and extra cost). Such arrangements are usually called ‘step-in rights’. In effect, these rights create an express contractual right for the benefit of the funder, and form part of their security package for the loan to the employer.

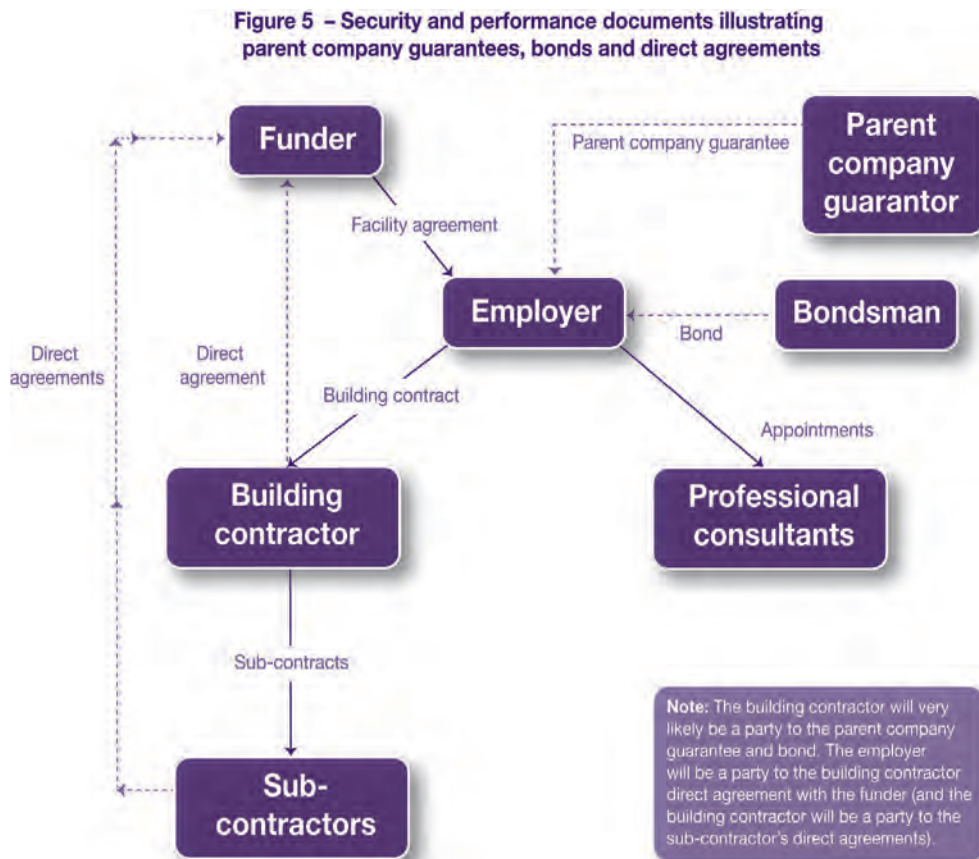
(b) In addition, credit risk in the construction industry is high, particularly as the construction supply chain often operates on unsecured credit. It may be necessary, therefore, to consider the manner in which insolvency risks (of the employer as well as the members of the supply chain) can be dealt with.

(c) Construction security and performance documents typically used in a construction project are:

- parent company guarantees
- bonds
- collateral warranties
- third party rights
- direct agreements; and
- payment security methods (such as escrow accounts and project bank accounts).

(d) Figure 5 illustrates the relationship between various parties on a typical project providing or receiving the benefit of parent company guarantees, bonds and direct agreements. Figures 6a and 6b illustrate typical arrangements between various parties giving or

receiving the benefit of collateral warranties or third party rights. Each project will have different requirements; it is not possible, within this guidance note, to examine all of the different permutations of the security documents that might be used.



1.4.2 Bonds and guarantees – an introduction

(a) It is important to understand basic legal principles relating to bonds and guarantees, which are forms of security often used in the construction industry. Bonds and guarantees have much in common but there can be a degree of misunderstanding about what each type of security is intended to achieve. This is not least because of the numerous descriptions given to them, such as ‘on demand bond’, ‘conditional bond’, ‘default bond’, ‘guarantee’, ‘performance bond’ and ‘parent company guarantee’. The description of the document itself may not be conclusive of the type of legal effect it actually has. Issuers of bonds and guarantees are variously described as ‘obligors’, ‘bondsmen’, ‘sureties’ or

‘guarantors’. For the purposes of this guidance note, they are referred to as bondsmen or guarantors. Those receiving the benefit of bonds and guarantees are often called ‘obligees’ or ‘beneficiaries’. They will be referred to as beneficiaries within this guidance note.

(b) It is important, in this context, to make a distinction between primary and secondary obligations:

- A primary obligation is (in the context of a bond or guarantee given to an employer) an undertaking from a bondsman to pay a sum of money to the employer without reference to the liability of the contractor. An example is where A promises to pay B up to £1 million if B (simply) asks A to do so, in writing. This is in the nature of an ‘on

Figure 6a – Collateral warranties/third party rights and 'traditional' procurement

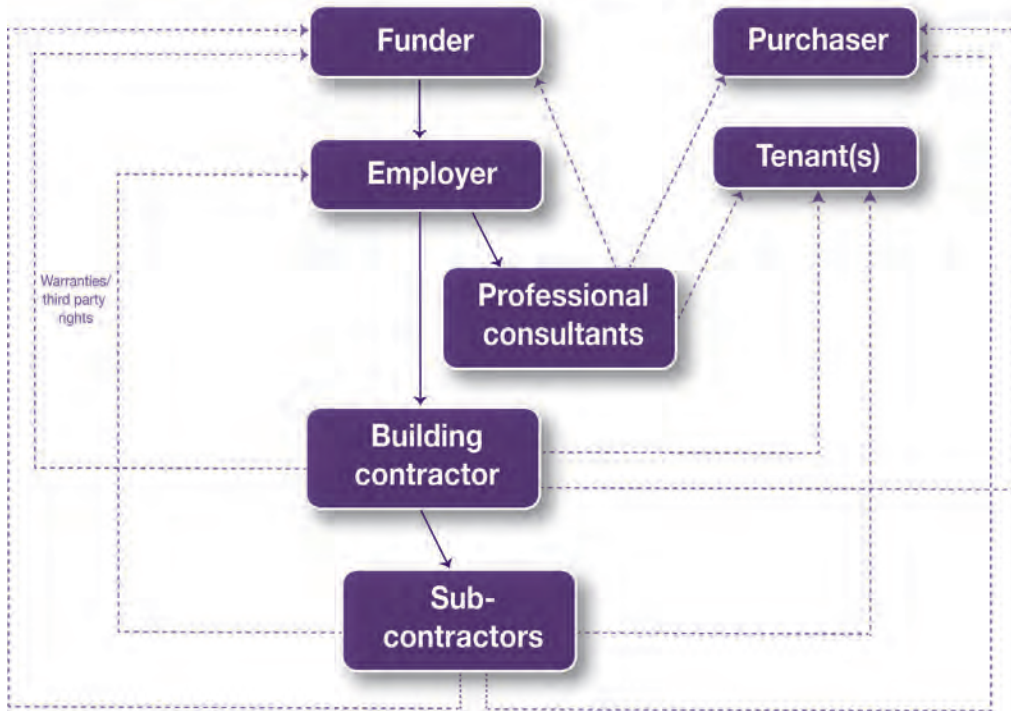
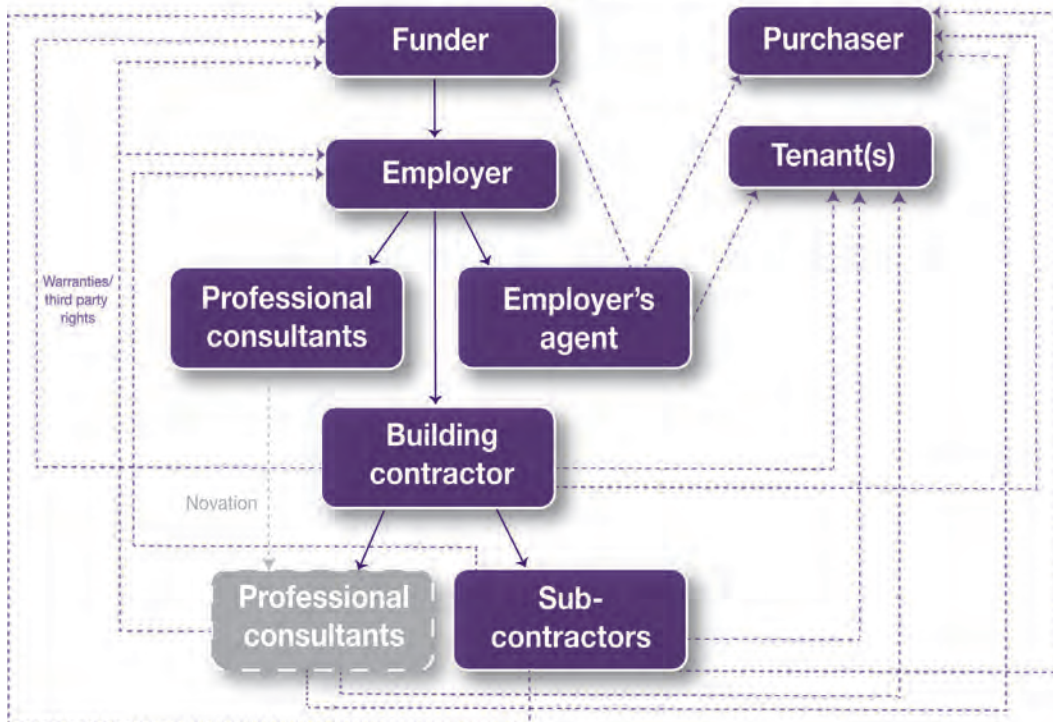


Figure 6b – Collateral warranties/third party rights and 'design & build' procurement



demand' bond. The more commonly used type of on demand bonds in the UK are advance payment, tender and retention bonds (which are discussed at paragraph 1.4.4(f)). However, on demand bonds are often used in PFI/PPP projects in the UK. Such bonds are usually of a conditional

nature in that they follow an on demand format but are subject to the condition that any demand has to be accompanied by an adjudication award. In other words, the bondsman would have to pay where liability is established following adjudication proceedings. On demand bonds are also

used in certain international projects; again, these may be of a conditional nature, usually by reference to a statement or certificate from the engineer or contract administrator that the contractor is in default.

- A secondary obligation is (again in the context of a bond or guarantee to an employer) one where its enforceability is dependent on a breach by the contractor of the underlying building contract in favour of the employer. This is in the nature of a suretyship, or guarantee, obligation. If the employer cannot establish a breach by the contractor, then the bondsman has no liability to pay. It is this principle that underpins the default, conditional or performance bonds, which are the commonly used forms of bond in UK construction projects.

(c) Bonds and guarantees provide a form of financial recourse in the event of risks occurring. In construction projects, bonds and guarantees are typically used as security for performance of the contractor but bonds and guarantees are increasingly provided as an alternative to retention monies and also as security for the employer's performance (i.e. payment). Where used as security for the contractor's performance, bonds are often treated as an alternative to a parent company guarantee, when in fact they are very likely to have different legal effects and provide different remedies.

(d) As a general point, the terms of any legal document (such as a bond or guarantee) must be examined very carefully in order to ascertain its effect. In particular, in the event of a claim, detailed consideration ought to be given to the circumstances in which any claim can be made and the precise requirements of any notice to be served, such as the form of the notice, the information to be provided within it, accompanying documents, the time for service, the correct address for service and so on.

1.4.3 Parent company guarantees

(a) A parent company guarantee is a contract between a parent company and a third party beneficiary by which the parent (as guarantor)

guarantees the performance of one of the subsidiaries. A 'parent company' may be a misnomer; the company giving the guarantee may be the ultimate holding company or another company within the group of companies of which the subsidiary forms a part.

(b) In the context of a typical project, this will most likely mean a parent company of the contractor guaranteeing to the employer the performance of the contractor under the building contract. A parent company guarantee is often expressed (in its simplest form) as 'A (the parent company) promises to B (the employer) that C (the subsidiary company) will perform their contract with B' and this is in the nature of a secondary obligation. However, it could also mean a parent company guaranteeing the payment obligations of an employer, as the subsidiary company, to a contractor under a building contract. As mentioned above, each document must be reviewed carefully to examine its correct legal effect. A guarantee, including a parent company guarantee, may seek to create a primary obligation, so that the guarantor is equally liable with the contractor and, therefore, the beneficiary of the guarantee may look to either for performance of the primary obligation.

1.4.4 Bonds

(a) In general terms, bonds are undertakings given by one party – a bondsman – to another to pay money if a third party defaults.

(b) Bonds are regularly procured by contractors in favour of employers, as security for losses caused to employers by a contractor default (the intention being to include insolvency). However, they may be procured by contractors in favour of employers in other instances, such as to cover advance payments, retention monies and tender costs.

(c) A bond will normally be required by an employer as a condition of entering into a building contract with the contractor. In the UK market, a commonly used form of bond is a performance bond. This is generally a default bond where the bondsman's liability is

secondary to that of the contractor, unless and until the contractor defaults. Such a bond often provides that before the bondsman is liable, the employer (as beneficiary) must demonstrate that the contractor has failed to comply with the relevant obligations under the building contract and that the employer has suffered loss as a result.

Insolvency itself is not a default and, if the employment of the contractor is determined as a result of insolvency (as most building contracts provide), the contractor's failure to complete the works is unlikely to constitute a default and the insolvency itself is not a breach of contract. As most forms of building contract provide for termination of the employment of the contractor in the event of insolvency, without making insolvency itself a breach, consideration should be given to insolvency being addressed expressly within the terms of the bond, so that the employer should be entitled to make a claim under the bond in such an event.

(d) A bond would normally have a financial limit on the bondsman's liability (typically up to ten per cent of the original contract sum) and a time limit within which a claim under it could be made (e.g. before practical completion or completion of making good of defects).

(e) On international construction projects, employers often require security for performance in the form of a primary obligation from the contractor's bank. This may be in the form of an on demand bond where a bank (as bondsman) is liable to pay on receipt of, for example, a simple statement (usually from the architect/engineer) that the contractor is in default of the underlying construction contract. These bonds are 'conditional on demand bonds'; while they impose conditions, they place little extra burden on the employer and should not take away from the fact that, essentially, they are on demand bonds. As mentioned previously, these bonds are relatively uncommon in the UK but can be seen in use in some UK PFI/PPP projects where 'adjudication bonds' are provided, i.e. bonds which are payable on demand but on condition of receipt by the bondsman of an adjudication award.

(f) On demand bonds tend not to be popular in the UK construction industry. Once the demand has been made and paid by the bondsman, the contractor (or whoever has procured the bond) then has to recover the payment if it is able to establish that the payment should not have been made or too much was paid. If the employer, as beneficiary, had become insolvent in the meantime, that would be the contractor's risk. There are, however, certain instances where there is a clear monetary risk and where an on demand bond may be appropriate, such as an advance payment, retention or tender bond. In essence, these are:

- **advance payment bond:** a bond used when the employer makes an advance payment to cover the contractor's costs for a particular part of the project
- **retention bond:** may be required when there is an early release of retention monies by the employer; and
- **tender (or bid) bond:** would entitle the employer to payment if they have incurred substantial costs in a tender process and the contractor withdraws their tender.

1.4.5 Collateral warranties

(a) As explained at paragraphs 1.1.3 and 1.1.4, a collateral warranty is a contract under which a professional consultant, contractor or sub-contractor generally warrants to an interested third party that they have complied with their professional appointment, building contract or sub-contract. Essentially, it creates a contractual link between the consultant/contractor/sub-contractor and the interested third party where one does not already exist. Without such a collateral warranty, an interested third party will have no effective contractual rights against the consultant, contractor or sub-contractor responsible for a defect in the project, or a funder would not be able to exercise a right of step-in, if required. The interested third party would also be unlikely to be able to claim their losses successfully under the tort of negligence.

(b) The forms of collateral warranty are usually annexed to the relevant contract (i.e. the appointment, building contract or sub-contract, as appropriate).

(c) There are likely to be commercial pressures on consultants, contractors and sub-contractors to agree to provide collateral warranties in favour of interested third parties. In other words, if a consultant, contractor or sub-contractor does not agree to give warranties and/or third party rights, that party may not be engaged by the employer (or contractor) for the purposes of the project. In practice, in many development projects involving interested third parties, it would be usual for consultants, contractors and sub-contractors with major design responsibilities to agree to provide collateral warranties (or third party rights), subject to agreement of the manner in which they will be provided and their terms, taking into account the conditions of their professional indemnity insurance policies.

1.4.6 Third party rights

(a) As discussed in paragraph 1.1.5, third party rights are similar to collateral warranties in that they aim to provide an interested third party with the same type of construction security. Third party rights allow an interested third party to enforce the terms of a professional appointment, building contract or sub-contract that, otherwise, such a third party could not enforce against the professional consultant, contractor or sub-contractor. The difference is that, whereas a warranty achieves this through a contract which is executed by the relevant parties, third party rights are granted by means of a statute (the TPR Act) to allow such an interested third party to have the benefit of the contractual provisions normally contained in a collateral warranty, without needing a separately executed contract. The interested third party can, therefore, rely on such provisions rather than have to finalise, print, sign and distribute an additional contract. Third party rights are becoming increasingly more acceptable to most interested third parties (and their provision is generally recognised within industry standard contracts as well as bespoke contracts). However, some interested third parties still prefer to have a written, signed and dated agreement in the form of a collateral warranty.

(b) Third party rights are usually specifically set out in the relevant contract (i.e. appointment,

building contract or sub-contract, as appropriate). They will normally be given to an interested third party by means of a notice issued by the employer to the consultant, contractor or sub-contractor.

(c) In practice, parties may exclude the operation of the TPR Act in contracts. If third party rights are to be given to interested third parties, they must be expressly included in the relevant underlying contract as third party rights available for the benefit of such interested third parties.

1.4.7 Direct agreements

(a) On more complex projects, particularly PFI/PPP projects and other major projects within the public sector, contractors and significant sub-contractors may be required to enter into direct agreements with funders.

(b) The purpose of direct agreements is to give the funder the opportunity, if the contractor or sub-contractors have a right to terminate their works, to step in, either directly or through a nominee or representative, to remedy the termination event or to substitute a new project company or contractor. Such an agreement creates an opportunity for the funder to complete the construction works and to minimise disruption to the income stream.

1.4.8 Payment security methods

(a) Payment security (i.e. securing the performance of payment obligations under a contract) may take a number of forms including:

- **Escrow accounts:** an account may be opened by an employer into which monies are deposited and can be released to the contractor under certain circumstances (e.g. on the issue of payment certificates under the building contract).
- **Project bank accounts:** a bank account opened usually in the names of the project parties into which the employer must make payments in accordance with the building contract. The funds are usually held in trust and released directly to the relevant members of the supply chain in accordance with their contractual entitlements.

(b) In each case, the intention is to leave the employer as nearly as possible in the same position as if they were simply making payment under the building or other project contract. However, both the escrow account and the project bank account are aimed at providing payment security to the supply chain against unjustified non-payment by, or the insolvency of, the employer and/or the main contractor.

(c) Other methods of payment security include a direct funder guarantee, an advance payment bond, irrevocable and unconditional letters of credit, or a parent company guarantee from the employer's 'parent'.

2 Practical application (Level 2 – Doing)

2.1 Introduction

This section looks in more detail at the nature and purpose of certain construction security and performance documents, including the parties that enter into them, an explanation of what these documents are intended to do and a review of general provisions.

2.2 Parent company guarantees

2.2.1 Parties

The parties are usually the employer, the contractor and a guarantor. While the most common position is the contractor procuring a parent company guarantee in favour of the employer, to provide protection in the event of a contractor default, in certain instances a contractor may require an employer to procure a guarantee of the employer's payment obligations. Ideally, the guarantor should be the ultimate parent company in the group but does not necessarily need to be where an intermediate company is of sufficient financial standing to be able to provide the guarantee. This guidance note focuses on the more usual position of a parent company guarantee being given on behalf of a contractor by their parent to an employer.

2.2.2 Purpose

In essence, if the contractor fails to perform their obligations under the building contract or becomes insolvent, the guarantor will perform, or be responsible for, the contractor's obligations instead. If the guarantor is the parent company of the contractor, they are required to see to it that the contractor performs and has sufficient funds to perform

(although, if a subsidiary is insolvent, it may be the case that the parent is also in financial difficulties).

2.2.3 General provisions

(a) The law relating to guarantees is complex and made more difficult by there being many different forms of guarantee. Specialist advice will usually be required. General legal principles relating to guarantees are briefly discussed at paragraph 1.4.2.

(b) The guarantee is commonly prepared by or on behalf of the employer although many contractors will offer their own forms or, more likely, amendments to the employer's form.

(c) A key provision will be one stating that the guarantor will perform the contractor's obligations in the event that the contractor becomes insolvent or fails to perform their contractual obligations or will be responsible for losses caused to the employer by defaults of the contractor. There may be conditions to, or limitations on, such guarantor's liability, e.g. that the guarantor's liability only arises if and when the contractor fails to perform the guaranteed obligations and then only to the same extent as the contractor. This wording suggests that the guarantee is of a secondary obligation nature but the wording of any guarantee would always have to be carefully reviewed. Many parent company guarantees create a primary obligation, so that the guarantor may be equally liable with the contractor.

(d) The guarantee will usually state that the guarantor will not be released from their obligations if there is an alteration to the terms of the building contract or any dispensation allowed to the contractor.

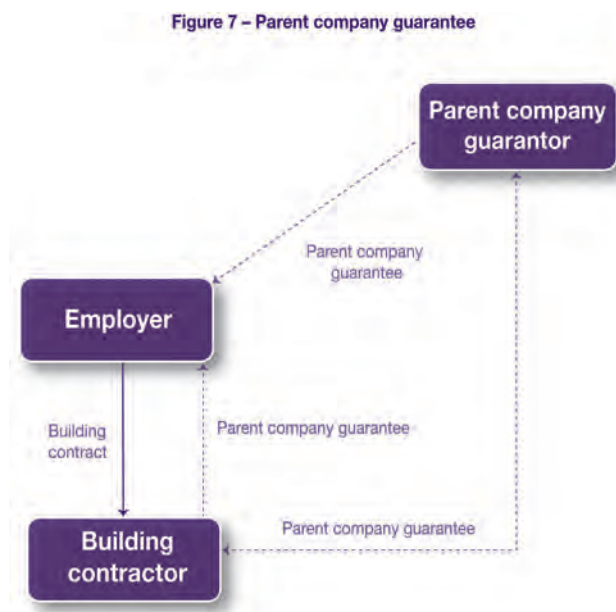
(e) There may also be a clause allowing the employer to assign the benefit of the guarantee

to another party, e.g. to a funder or a party taking over the employer's interest in the project.

(f) The guarantee may also include:

- a 'no greater liability' provision, which allows the parent company to use limitations or exclusions of liability which the subsidiary company may have agreed with the employer under their building contract in any claim brought under the parent company guarantee
- an expiry date following which the parent company guarantee will cease to be effective (save, as a general rule, for claims made before that expiry date); and
- a dispute resolution procedure, setting out the rules and method of resolving any disputes which may arise.

Figure 7 illustrates a parent company guarantee arrangement where the obligations of a contractor are guaranteed by their parent in favour of an employer.



2.3 Bonds

2.3.1 Parties

The parties are usually the employer, the contractor and a bondsman, which is often the contractor's bank or an insurance company. The bondsman will generally require an indemnity or other security from the contractor before giving the bond.

2.3.2 Purpose

In general terms, bonds provide security for performance by the contractor and cover the costs of the employer (up to a financial limit) in the event of a contractor default, such as the additional costs associated with appointing a substitute contractor to complete the works. This guidance note focuses on bonds procured in favour of the employer by a contractor (but sometimes contractors require employers to be bonded to secure the employer's payment obligations). The bondsman undertakes to pay to the employer a sum of money if the contractor fails to perform their obligations under the building contract. The employer often sees the bond as part of their construction security package designed to minimise or reduce the impact of contractor insolvency. Bonds differ from parent company guarantees in that they provide financial compensation in the event that a contractor fails to perform their obligations, whereas a parent company guarantee is intended to guarantee that the obligations are performed, which may result in financial compensation or, in certain instances, the parent company finishing the works if the contractor is unable to do so.

2.3.3 Types of bond

(a) There are a wide range of bonds available; some are drafted specifically for the project but standard forms are also available (such as the model form of guarantee bond published by the Association of British Insurers (ABI)) although they tend to be amended by the parties. The negotiations dealing with bonds are often left until late in the procurement process. The terms of any bond need to be reviewed very carefully (and appropriate advice taken as required).

(b) The general legal principles relating to bonds are briefly discussed at paragraph 1.4.2, including the differences in terminology. As mentioned, there are a variety of types of bond, including the following:

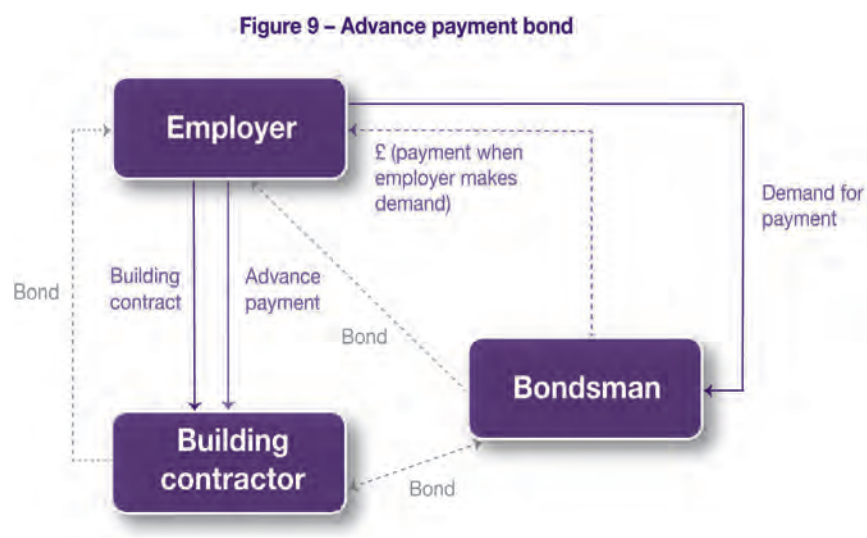
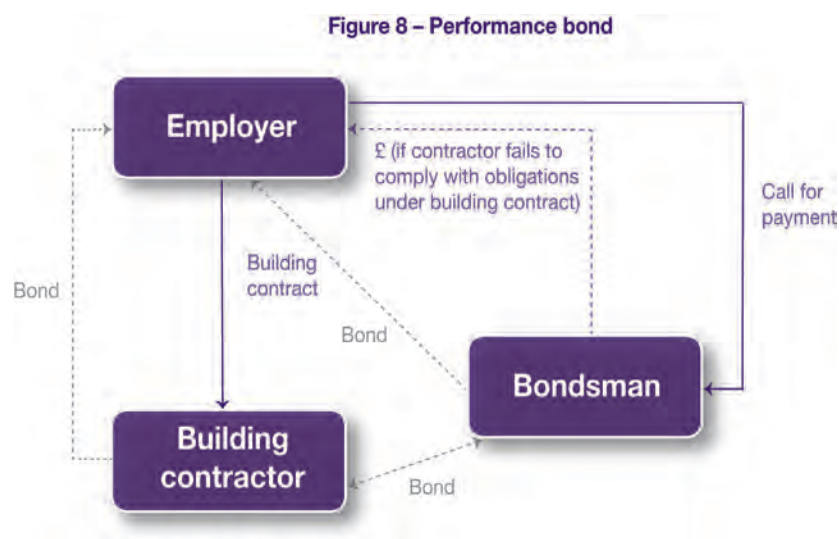
- **Performance bonds:** the most commonly used forms of performance bonds in a UK construction project are default bonds issued by a bondsman on behalf of a

contractor, i.e. they are conditional on the proper performance of the building contract by the contractor. If the contractor does not perform their obligations in accordance with the building contract, the bondsman agrees to pay the employer their losses up to a stated maximum sum, often a percentage of the initial contract sum. Figure 8 illustrates the operation of a performance bond.

- **Advance payment bonds:** used when the employer makes an advance payment (sometimes called a 'down payment') to cover the contractor's setting up costs or

costs for a particular part of the project. There may be good commercial reasons for the employer making such advances, primarily a saving on the contract price. Unless the employer retains some control over the advance, it may be diverted to some other use within the contractor's organisation. The bond, therefore, protects the employer and can be called if the monies advanced are not used for the project. They are generally on demand bonds.

Figure 9 illustrates the operation of an advance payment bond.



- **Retention bonds:** may be required where there is early release of retention monies or payment under a building contract gross without deduction. These are generally on demand bonds which require the bondsman to pay a sum equivalent to the retention monies, which would otherwise have been retained from payments due under the building contract.

Figure 10 illustrates a retention bond structure.

- **Tender (or bid) bonds:** in general, entitle the employer to payment if, after they have

spent a great deal of time and expense negotiating with a contractor, the contractor then withdraws their tender and refuses to contract with the employer, possibly delaying the project and forcing a re-tender. The amount stated in the bond may be a specific sum or a percentage of the tender price subject to a maximum sum. Such bonds are generally on demand bonds but are relatively unusual in domestic UK construction projects.

Figure 11 illustrates the structure of a tender bond.

Figure 10 – Retention bond

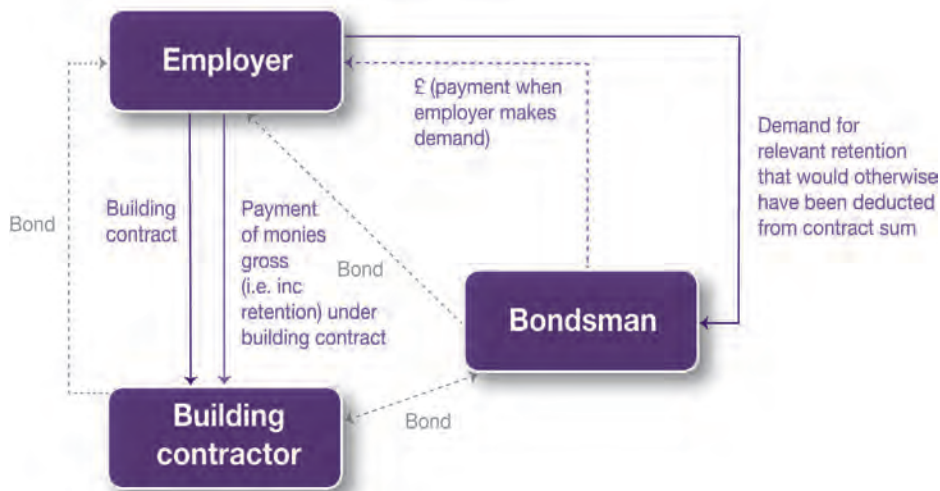
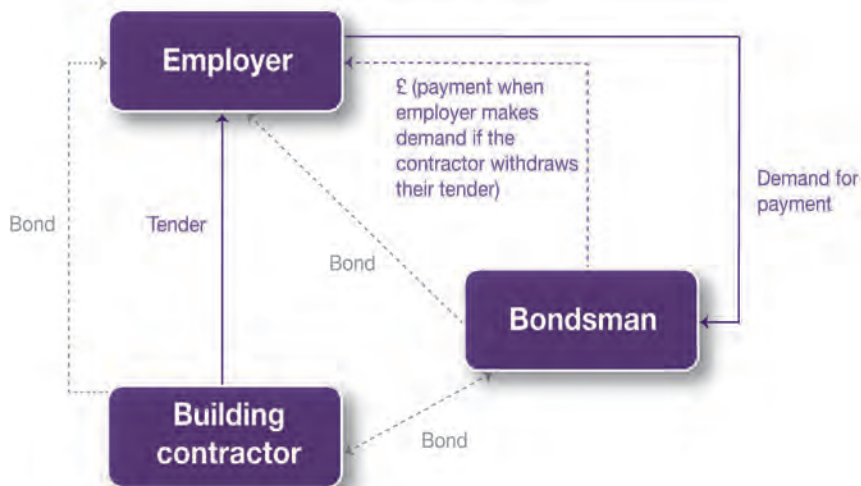


Figure 11 – Tender (or bid) bond



2.3.4 General provisions

These will depend on the type of bond being provided. However, bonds will usually contain key provisions setting out the amount of the bond, the circumstances in which a call or a demand under the bond can be made, the procedures which need to be followed when making a call or demand and an expiry date.

2.4 Collateral warranties

2.4.1 Parties

Collateral warranties are normally given by contractors, certain sub-contractors and the professional consultants (often called ‘warrantors’) in favour of one or more interested third parties. The employer is also often a party to the warranty document in order to consent to the arrangement. In some instances (usually in a design and build method of procurement), warranties are also given to the employer by the professional consultants employed by the contractor (the consultants are often originally appointed by the employer and their appointments novated (or transferred) to the contractor on or before the commencement of construction, in which event they will normally provide a collateral warranty to the employer).

2.4.2 Purpose

A collateral warranty is a contract between a third party with an interest in the project under construction, or the completed project, and a person who is or was involved in the design, management and/or construction of that project. When taking an interest in a new, recently built, or recently refurbished property, an interested third party will usually want to minimise the risk that they will have to pay for the remedy of any problems or defects in that property or project – they want construction security. A funder providing development finance to an employer will also want construction security to help protect their loan. In other words, if something goes wrong on the project, the interested third parties will want to recover any losses from those responsible – collateral warranties should enable them to do so. A funder may also want to be able to step

in and build out the project if the employer defaults in some way (e.g. becomes insolvent) before the project is completed. The collateral warranty enables the funder to do this by using step-in rights, although the funder is usually obliged to make good any payments then outstanding to the warrantor before it can exercise those step-in rights.

A collateral warranty, therefore, creates a duty and set of rights in contract in favour of the interested third party, which would not otherwise have existed because of the doctrine of privity of contract, which is explained at paragraph 1.1.3. Without such a contractual link, a third party is very unlikely to have any successful right of legal recourse against the party which was responsible for a defect in the design and/or construction of the project (whether in contract or tort). This is explained in greater detail at paragraphs 1.1.3 and 1.1.4.

2.4.3 The beneficiaries of warranties

Warranties may be given by contractors, sub-contractors and professional consultants in favour of:

- the employer (if they have not directly employed the warrantor)
- funders
- any purchaser or tenant of the whole and/or any part of a newly built property once it is completed; and/or
- other interested parties, such as freeholders and management companies.

2.4.4 General provisions

(a) Warranties usually contain an undertaking from the warrantor in favour of the interested third party that the warrantor has performed and/or is performing their works and/or services to the standard required under their primary underlying contract with the employer. For example, a warranty from a consultant might state that the consultant ‘warrants to [the interested third party] that it has performed and will continue to perform the services exercising the reasonable skill, care and diligence to be expected of a competent consultant of the relevant discipline who is experienced in providing similar services in connection with

projects of a similar size, scope and complexity to the Project and otherwise in accordance with the terms of the Appointment’.

(b) If the warrantor has any significant design liability, there will usually be an obligation in the warranty that the warrantor should maintain professional indemnity insurance up to an agreed level and for a specified period. The warrantor would normally also be required to provide evidence that such insurance cover is in place.

(c) There may be an obligation on the warrantor not to specify or incorporate (or allow to be incorporated) in the works certain prohibited materials. Sometimes these materials are specifically listed in the warranties, or the warranty could simply refer to an agreed materials standard or standards.

(d) There may be provisions limiting the warrantor’s liability. For example, there may be a clause limiting the liability of the warrantor to a certain amount (often linked to the level of their professional indemnity insurance cover). There could also be clauses restricting the losses which a third party beneficiary might be able to recover from a warrantor in the event of

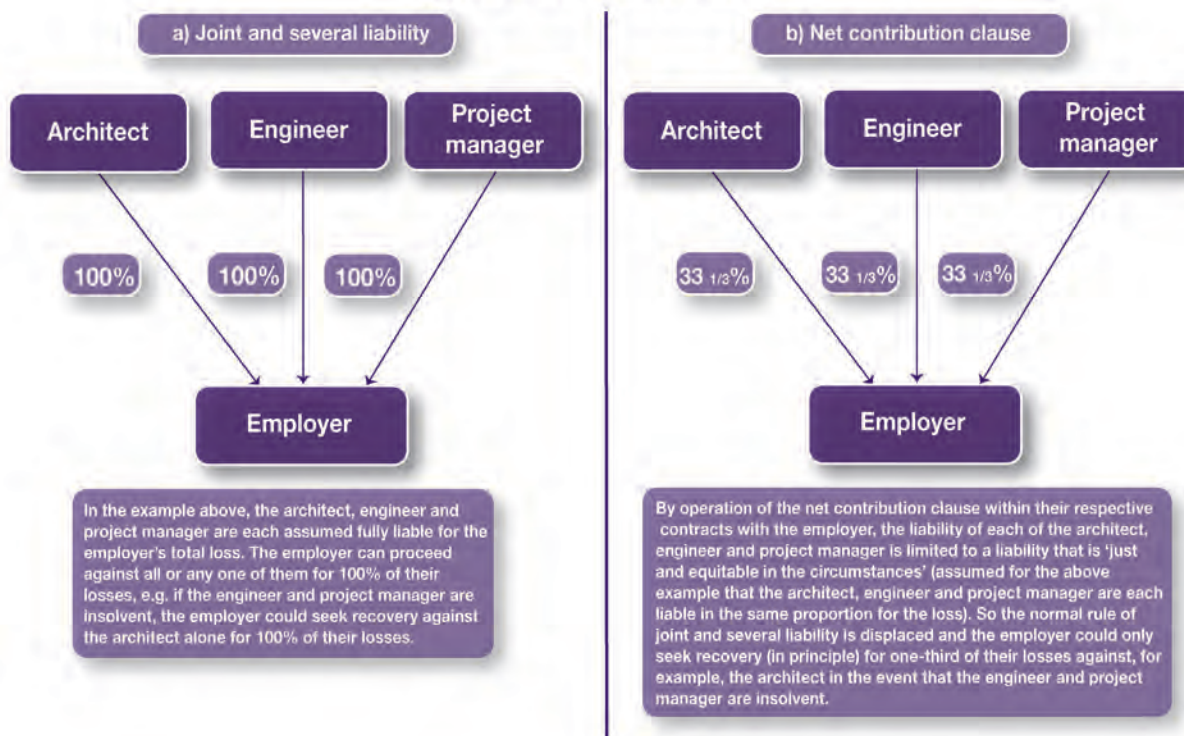
a claim, e.g. to the reasonable cost of repair, renewal and/or reinstatement of the property caused by the warrantor’s breach (so that, among other things, loss of rents cannot be recovered).

(e) Some warranties may also contain a ‘net contribution’ clause which states that the warrantor’s liability should be limited to such sum as is ‘just and equitable’ (in other words, fair), given its responsibility for the loss or damage suffered and certain stated assumptions.

Figure 12 illustrates how a net contribution clause can work.

(f) A warranty typically includes a ‘no greater liability’ and/or ‘equivalent rights of defence’ clause. A no greater liability clause provides that the warrantor cannot have a greater liability under the collateral warranty to the interested third party than they would have to the employer under the appointment or building contract. An ‘equivalent rights of defence’ clause provides that the warrantor may use any defence that they may have under the professional appointment or building contract to defend a claim from the interested third party beneficiary under the collateral warranty.

Figure 12 – Net contribution clauses



These types of provisions might allow, among other things, a right of set-off, i.e. the right for the warrantor to set-off the amount of any claim which they may have against their employer (such as for non-payment of fees or for unpaid works) against any claim made by the interested third party beneficiary under a warranty. Such a right of set-off by the warrantor may be expressly excluded by the terms of the collateral warranty, i.e. the warrantor would not in the circumstance be able to put forward a right of set-off in any claim by the interested third party under the warranty.

These types of clauses are the reason why an interested third party beneficiary would very likely want to review the terms of the appointment and/or building contract when negotiating and agreeing the terms of a collateral warranty, because the benefits given by a collateral warranty (or by third party rights) may be limited by the terms of the principal underlying contract itself. This also applies to sub-contracts where sub-contractor warranties are being provided. Copies of sub-contracts will (most likely) also need to be supplied to each interested third party beneficiary of collateral warranties or third party rights, with commercial information edited out.

(g) When the warrantor is responsible for design, the warrantor will usually retain copyright in their design, but the beneficiary would be granted a copyright licence to use and reproduce design documents prepared by the warrantor for certain purposes. Sometimes, there is not only a provision in a warranty granting a licence in respect of copyright, but also an indemnity provision indemnifying the interested third party in respect of any claim it may suffer as a result of the warrantor infringing or being held to infringe any copyright. There may also be a provision stating that the warrantor shall not be liable under the collateral warranty for any misuse by the beneficiary of design documents and materials (i.e. any use other than that for which such documents and materials were prepared by the warrantor).

(h) The beneficiary of a warranty may want the right to assign the benefit of the warranty to

another party who takes that beneficiary's interest in the project (and further onward assignments). The warrantor will often seek to limit this right, e.g. by limiting the number of times the benefit of the warranty can be assigned.

(i) Parties providing warranties should normally seek to review their terms with their legal or insurance advisers before they are agreed, since they are long-term obligations. The form of warranty is often agreed in tandem with the appointment or building contract so that, in effect, the warranty represents a document negotiated and agreed between the parties at the outset, often long before the warranty has to be given.

Figures 6a and 6b illustrate projects where collateral warranties are being given and received by relevant parties.

2.5 Third party rights

2.5.1 Parties

A relevant party (contractor, sub-contractor or consultant) agrees in the terms of the relevant underlying contract (i.e. the building contract, sub-contract or appointment) to give third party rights to an interested third party.

2.5.2 Purpose

Third party rights allow an interested third party to enforce a specific term (or set of terms) in the underlying contract, which that third party would otherwise not have been able to do because they are not a party to that contract. The purpose of third party rights in most UK construction projects is to establish a contractual relationship in the same manner as a collateral warranty. This is achieved by means of statute – the TPR Act – which allows a third party beneficiary to have the benefit of contractual provisions (such as those normally contained in a collateral warranty) without the need for a separate, signed and executed, contract. The background and effect of the TPR Act is described in greater detail at paragraph 1.1.5.

2.5.3 The beneficiaries of third party rights

Third party rights may be given by contractors, sub-contractors and consultants in favour of:

- the employer (if they have not directly employed the party giving the third party rights)
- funders
- any purchaser or tenant of the whole and/or any part of a newly built property once it is completed; and/or
- other interested third parties, such as freeholders and management companies.

2.5.4 General provisions

Third party rights are a set of rights granted by one party in favour of another (third) party who is not a party to the contract, to enforce certain terms of a contract. Third party rights commonly appear either within a standalone schedule to the building contract, sub-contract or appointment setting out the terms that an interested third party may enforce, or as a schedule listing the clauses that an interested third party may enforce. There should be a provision within the relevant underlying contract setting out how such third party rights are effectively granted in favour of an interested third party. Usually, this is by means of a notice served by the employer on the party providing the benefit of the third party rights which will identify the interested third party in whose favour such third party rights are being given. Third party rights are similar or equivalent to the general provisions discussed at paragraph 2.4.4 in the context of collateral warranties.

Parties giving third party rights will be in the same position as parties providing collateral warranties and will normally wish to review the terms of such third party rights with their legal or insurance advisers before they are agreed. A party receiving the benefit of third party rights would, as in the case of collateral warranties, very likely want to review the relevant contract under which such rights are purported to be given. This would not only be because the benefits received under third party rights may be subject to the terms of such contract but

also to check the manner in which such third party rights are being conferred on them.

Figures 6a and 6b illustrate projects where third party rights are being given and received by relevant parties.

2.6 Direct agreements

2.6.1 Parties

The parties are the funder and the contractor and, sometimes, the funder and key sub-contractors. The employer is also usually a party to the agreement to show their consent to the arrangements within it.

2.6.2 Purpose

Direct agreements generally allow the funder to step into the shoes of the employer in the event that the employer becomes insolvent or defaults in relation to the loan obligations they owe to the funder under the facility agreement. Funders will usually require direct agreements in relation to the building contract, important sub-contracts and other key agreements used in larger projects, such as operating/facilities management agreements (which operate once the project has been constructed).

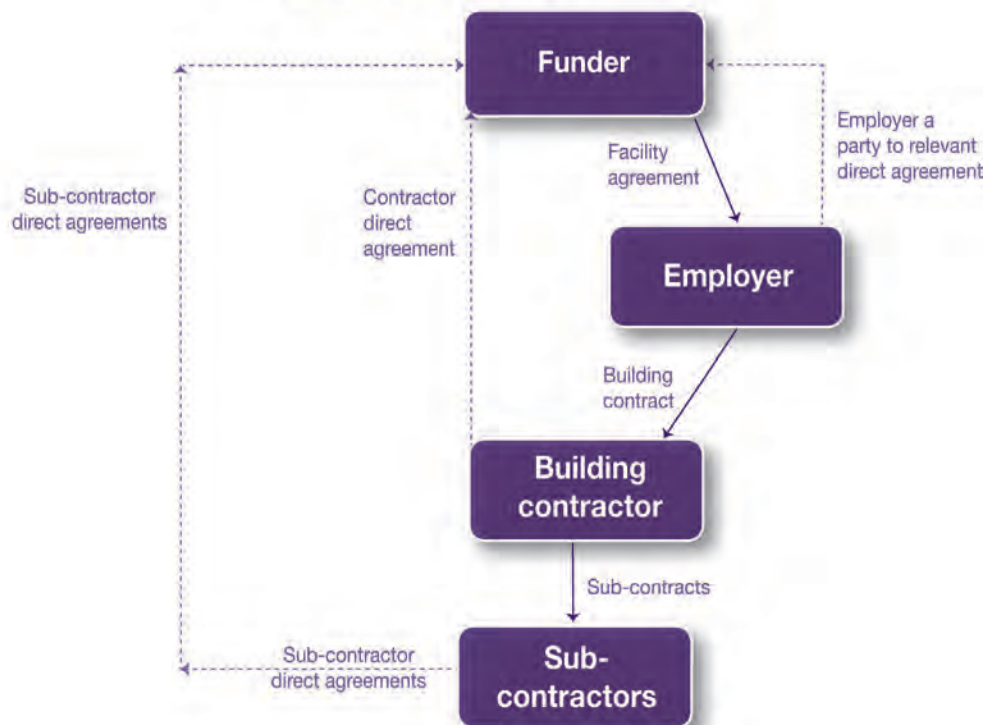
2.6.3 General provisions

A key provision is a step-in clause which allows the funder to take control of the relevant contract following an event of default by the employer. The funder will usually have the power to arrange for a new body/project company to take over the administration of the project from the employer.

The direct agreement will usually require the other parties to the relevant contract (such as the contractor in the case of the building contract) to forego or suspend any rights they might have to terminate the contract while the funder finds a substitute project company. The clause will usually require the funder to find a body with the same level of experience and financial resources as the original employer.

Figure 13 illustrates the structure where direct agreements are entered into relating to a property development transaction.

Figure 13 – Structure of a direct agreement relating to a property development transaction



2.7 Payment security methods

2.7.1 Escrow account

A typical building contract requires regular payments by the employer to the contractor as work progresses. An escrow account may be used as a safeguard for all payments or it may be put in place as a safeguard to be called upon only if the employer fails to make one of the payments owing under the building contract.

2.7.2 General provisions

An escrow account is usually documented by the following:

- a contract that formalises the escrow arrangements
- a letter instructing the bank or other escrow agent how to operate the account; and/or
- an amendment to the building contract to adjust the payment provisions to take account of the escrow arrangements.

The contracts should clearly set out what sums are to be paid into the escrow account and

when and how the funds are to be distributed from the account. There may be provisions under which the monies in an escrow account are held on trust for the contractor in order to ring-fence such monies in the event of employer insolvency.

2.7.3 Project bank account

A project bank account is intended to speed up payment in a construction project, reducing the risk of cash flow problems in the supply chain. This is because, depending on the terms of the relevant agreements, a payment from the employer to the contractor does not have to flow down from the contractor to their sub-contractors – they are all paid at the appropriate time through the project bank account. In essence, the employer and generally the main contractor jointly open the project bank account and money is paid into it by the employer in accordance with the contractor's contractual entitlements. The monies in the account are usually held in trust by the employer and the contractor for the benefit of the contractor and their supply chain. Therefore, the supply chain should have access

to the monies if the contractor becomes insolvent. Project bank accounts are more likely to be seen in public sector projects but are increasingly being used on major projects.

2.7.4 General provisions

There will normally be a provision in the building contract setting out the project bank account provisions. There may then be a separate agreement dealing with the project bank account itself. The key provision is an undertaking from the employer to pay monies due under the building contract into the project bank account as and when they become due. The contractor will identify sub-contractors that will be paid directly from the account. There may be provisions stating that the monies paid into the account are kept separate and distinct and clearly identifiable, and that they will be held on trust for the contractor and other relevant parties until they are ultimately paid. As with the escrow account provisions referred to previously, the intention is to create a trust, ring-fencing the funds in the account for the benefit of the parties to be paid in connection with the project.

3 Practical considerations (Level 3 – Doing/Advising)

3.1 Introduction

This section looks at practical considerations which a chartered surveyor should take into account when reviewing construction security and performance documents in a construction project. It is important to note, however, that this guidance note is a brief introduction and should not be relied on as a substitute for appropriate professional advice.

3.2 Parent company guarantees – items for consideration

3.2.1 The form of parent company guarantee is usually prepared by the employer, although major contractors often have their own forms of guarantee that they prefer to use to guarantee the performance of a subsidiary on a particular project. The law relating to guarantees is complex; specialist advice should be sought, where appropriate. Background information on the general principles of law in this area is provided at paragraph 1.4.2.

3.2.2 The parties should carefully consider the reasons for a parent company guarantee and (if appropriate) any additional or alternative security that the contractor or the employer may be able to provide, e.g. in the case of a building contract, if a performance bond is being provided, is it necessary to provide a parent company guarantee as well? This will depend on the particular project: often, in complex projects, both will be required. Performance bonds and parent company guarantees provide different remedies, types and levels of protection to the employer for contractor default. Bonds (among other things) provide access to a pot of money to cover the cost of appointing a substitute contractor if the

original contractor becomes insolvent; parent company guarantees attempt to ensure that the parent will ‘see to it’ that their subsidiary performs in a potential default situation. Clearly, if the contractor does not have a parent company (or other appropriate company within the group) a parent company guarantee cannot be given and other security (such as a bond) may be sought.

3.2.3 Consideration should be given to which body is providing the parent company guarantee. Is it the ultimate holding company in the group or an intermediate company? Where exactly does the company giving the guarantee sit within the company’s overall group structure? Financial checks on the body providing the guarantee will be required. The aim should be to obtain a guarantee from a company within the group which owns significant assets. For example, in the case of an employer, it is common in many development projects for developers to set up special purpose vehicles (SPVs) which have very few assets. The important point is to undertake financial checks; such checks may show that the parent company or even the ultimate holding company have fewer assets than the contracting party themselves, which would therefore mean that any parent company guarantee given by these companies will be of little additional value. However, it may be difficult, in practice, to ascertain where control and ownership of the group assets really lie. A parent company guarantee will, of course, be of little or no benefit if the parent is ultimately equally unable to perform the contract (e.g. if there is a group insolvency). This is likely to be a factor to consider in choosing whether to have a performance bond in place of, or as well as, a parent company guarantee.

3.2.4 Where is the company giving the guarantee resident? Is it a company registered

in the UK or an overseas company? It would be necessary to consider what assets any overseas company has (and it may be difficult to carry out financial checks or, at least, financial checks which are then current) and how any judgment could be obtained or enforced against that company in the event of a claim under the guarantee.

3.2.5 In what circumstances will the guarantor be liable under the parent company guarantee? For example, does the guarantee cover the contractor's insolvency? There is legal authority to suggest that insolvency itself is not automatically a breach of a building contract (see paragraph 1.4.4(c) for further details). Is insolvency defined in the guarantee and is it a satisfactory up-to-date definition?

3.2.6 Is the parent company guarantee a 'see to it' guarantee or an indemnity? If the guarantor's guarantee of the contractor is a secondary obligation, the guarantor's liability arises if and when the contractor fails to perform the guaranteed obligations. A guarantee may, however, include a primary obligation, such as an indemnity, where the guarantor's obligation is independent of the contractor's obligations to the employer under the building contract and may extend beyond the scope of such obligations.

3.2.7 Does the parent company guarantee include a provision which states that the guarantor is not released from its liabilities under the guarantee if an amendment is made to the building contract or if some other form of dispensation is given under it (such as an extension of time to the date for completion of the works)? An amendment to, or dispensation under, the building contract (or underlying guaranteed obligations) without the guarantor's consent may release the guarantor from the guarantee.

3.2.8 What is the duration of the liability of the guarantor under the parent company guarantee? Is the guarantee effective as long as the obligations and liabilities of the contractor remain alive under the building contract, or does the liability of the guarantor cease at a particular time, such as on completion of making good defects?

3.2.9 Is there any limitation of liability provision within the parent company guarantee? From the employer's perspective, the guarantor should be liable at least to the same extent as the contractor. Subject to this, it might be reasonable to expect the guarantor to want to include a provision within the guarantee that the guarantor should not be more liable to the employer than the contractor is under the building contract.

3.2.10 A funder will typically require the benefit of a guarantee to be charged to them by way of security for their loan (along with the benefit of any other security documents). An employer will, therefore, want to be able to assign and charge the benefit of the guarantee as well as the building contract. Most parent company guarantees will, therefore, include an appropriate assignment provision.

3.2.11 How is the parent company guarantee to be executed and by whom? A parent company guarantee will most likely be executed as a deed rather than as a simple agreement (i.e. simply signed by the parties). A document can be executed as a deed by a company by using their common seal, which must be affixed and authenticated in accordance with that company's Articles of Association. A company could also execute a document as a deed by two directors executing the document, or one director and a company secretary, or even by one director in the presence of a witness who then attests that director's signature. If the parent company is a foreign entity, there may be different rules regarding execution – it may be necessary to ask a law firm in the company's home country to produce a legal opinion stating that the parent company is properly formed, has the power to enter into the guarantee and has executed it in compliance with the laws of that country.

3.3 Bonds – items for consideration

3.3.1 Bonds are generally issued by specialist surety companies, insurance companies or banks. An employer may have a particular bespoke form of bond that the employer will want a bondsman to sign but often the

bondsman will want to introduce amendments or their own form of bond. Certain standard form bonds are on the market (such as the model form of guarantee bond published by the ABI). Careful consideration should be given to the terms of whatever form of bond is offered and, if necessary, appropriate advice sought (such as legal and financial advice).

3.3.2 As mentioned, in the context of a parent company guarantee in paragraph 3.2.2, consideration should be given as to whether both a bond and parent company guarantee are required. An employer will wish to have sufficient security in place in the event of a contractor default (such as insolvency). Often the decision is out of the employer's hands as their funder may insist on both being procured. A contractor may be unwilling to offer both and, of course, there is a price for doing so. A contractor will normally charge a premium for the provision of a performance bond whereas a parent company guarantee should not have cost implications for the contractor (save, perhaps, for an administration charge). It may, however, be a contingent liability in the contractor's books and may affect the amount of money they can borrow.

3.3.3 It is worth noting (in making a decision as to whether both are required) that bonds and guarantees are designed to protect against different risks. The bond is designed to provide relatively short term cover for a contractor default and a parent company guarantee acts as longer term security (generally for the duration of the contractor's liability under the underlying guaranteed contract).

3.3.4 As with a party providing a parent company guarantee, it is necessary to consider the status and financial worth of the body providing the bond including, where applicable, its financial rating. Other financial checks on the bondsman are likely to be required. Where is the body resident? Is it a company registered in the UK or an overseas company? It will be necessary to check the financial status of any overseas body (and it may be difficult to carry out current financial checks) and how any judgment could be obtained or enforced against that company in the event of a claim under the bond.

3.3.5 Check the form of the bond and its purpose. A commonly used form of bond in a UK development project is a performance bond (see paragraphs 1.4.4(c) and 2.3.3(b)). Is the bondsman undertaking to pay a sum of money to the employer if the contractor fails to perform their obligations under the building contract? Does the bond cover the contractor's insolvency? As mentioned in the context of a bond (see paragraph 1.4.4(c)), insolvency of itself is not, strictly speaking, a breach of a building contract. Therefore, it is necessary to examine whether the terms of the bond expressly cover this event (and to review how insolvency in this context is defined in the bond, e.g. is it by reference to a particular definition in the building contract and is that definition satisfactory?). Further, is the bond of an on demand nature (see paragraph 1.4.2(b)), perhaps conditional on the presentation of documentation (such as a statement from the contract administrator that the contractor is in default)? As mentioned, on demand bonds are less commonly seen in UK projects but their use may increase during periods of economic downturn. Certain on demand bonds of a conditional nature are often used in UK PFI/PPP projects, such as adjudication bonds (see paragraph 1.4.2(b)). Bonds are usually of an on demand nature if they cover advance payments, retention monies or tender costs.

3.3.6 What is the sum covered by the bond? Bonds normally have a limit on the amount available to be called by the employer under their terms. The maximum amount of cover available is often expressed as a percentage of the original contract sum, usually ten per cent.

3.3.7 When does the bond expire? Bonds normally have an expiry date. This could be a specified date, the date of issue of a certificate under the building contract or some other event anticipated by the contract. A request may be made on behalf of the contractor or the bondsman for the bond to expire on the issue of a statement or certificate of practical completion. An employer is likely to want the bond to remain alive during the defects liability period until the issue of a statement or certificate of completion of making good defects.

3.3.8 The bond may be a reducing bond, reducing from, say, ten per cent to five per cent on practical completion, with the remaining five per cent being extinguished on completion of making good defects. To make a specific expiry date enforceable, the bond would have to provide that after expiry the bondsman ceases to be liable to the employer absolutely. In those circumstances, it is important from the employer's perspective to check that the cut-off date does not apply to claims already notified by the employer to the bondsman before that date.

3.3.9 As with a parent company guarantee, a funder will typically require the benefit of a bond to be charged to it. Most bonds will, therefore, contain an assignment provision.

3.3.10 If a call is to be made under the bond, it will be necessary to check the requirements that need to be followed, e.g. is it a condition that a demand has to be made within a particular period after a relevant default has occurred? It will be necessary to review the formal requirements of notifying a claim or issuing a demand under any bond. Detailed consideration needs to be given to the precise requirements of any claim or demand to be served, such as the form of the notice, the information to be provided within it, accompanying documents, the time for service, the correct address for service and so on. Any requirements of this nature must be strictly complied with otherwise the claims may be rejected by the bondsman.

3.3.11 How is the bond to be executed and by whom? Usually, the bond is to be executed by both the bondsman and the contractor. It will normally be executed as a deed, so checks will need to be made to ensure that it has been properly executed in accordance with the law of the place where the bondsman is resident. If the bondsman is a foreign entity, there may be different rules regarding execution – it may be necessary to ask a law firm in the company's home country to produce a legal opinion stating that the bondsman is properly formed, entitled to issue bonds in the circumstances envisaged and has executed the bond in compliance with the laws of that country.

3.4 Collateral warranties – items for consideration

3.4.1 By a collateral warranty, parties responsible for the design and/or construction of the project (contractors, sub-contractors and consultants) promise an interested third party beneficiary to carry out the works or services in accordance with the underlying contract (such as the building contract, sub-contract or consultant appointment). The commercial property development market often refers to these collateral warranties as 'purchaser or tenant' or 'funder' warranties. Other specialist sectors (e.g. the public sector in PFI/PPP projects) use different forms or variants of collateral warranties – 'direct agreements' – in favour of parties relevant to their sector. Direct agreements are discussed in more detail at paragraph 3.7.

3.4.2 Does a warranty have to be given? A warranty would not have to be given unless there is a binding obligation upon a party to give it. It would be rare, in most development projects, for such an obligation not to be included within the underlying contracts, such as the building contract, sub-contracts and appointments. This is because of the requirement of interested third parties to have such warranties in place (often as a precondition to funding or their agreement to purchase or take a lease of the property). There may be incentives to give the warranties within the contract, such as the right of the employer to withhold monies until the warranty is given, or a requirement for the beneficiary to pay a stated amount to the warrantor for giving the warranty (although this is often a nominal amount). However, there is normally sufficient commercial pressure on consultants, contractors and sub-contractors to agree to provide collateral warranties. As employers are normally required to procure such warranties in favour of interested third parties, they will only want to engage consultants and contractors who are willing to give them.

3.4.3 The form of warranty which the warrantor is to give to interested third parties will often be annexed to the underlying contract. This could be a standard form published by a relevant

organisation but in most major projects the warranty is likely to be in a bespoke form prepared by the employer. In either case, the warrantor has the opportunity to agree the form of warranty often long before they will have to give it. In the case of building contracts, an issue can arise where the contractor has to procure sub-contractor warranties. This is because it is often the case that the agreement of sub-contract terms only takes place following the completion of the building contract. As a result, the contractor may be agreeing to procure sub-contractor warranties in favour of interested third parties in a form which they have not yet agreed with the sub-contractors.

3.4.4 Check whether there are any limitations on the obligation to give collateral warranties within the underlying contract. Is there a limitation on the types of beneficiaries to whom warranties have to be given or a limit on the number that can be given? The party providing a warranty may stipulate, for example, that their warranty should only be given to a 'first' tenant (the original tenant taking a first letting within the building), to a tenant who is taking a 'substantial' letting (this wording is often used but begs the question of what is 'substantial'?), to a limited number of tenants, or a combination of these elements.

The obligation to provide a fixed number of warranties (e.g. five in total) should not be confused with the ability of a third party beneficiary to assign the benefit of a warranty to another party who may, for example, be taking their interest in the project. Taking this example further, Consultant X agrees to provide a total of five warranties which are given to tenants A, B, C, D and E. No more warranties are available to be given by Consultant X. However, each warranty may be assignable so that, for example, Tenant A can assign the benefit of the warranty to a substitute tenant (A1) taking A's interest in the property.

3.4.5 A collateral warranty usually includes a clause in favour of the interested third party that requires the warrantor to confirm that they have complied, and will comply, with the terms of the professional appointment or building contract they have entered into with the

employer. Additionally, where the warrantor has a design responsibility, collateral warranties will usually include an obligation to comply with the professional appointment or building contract and an obligation to exercise reasonable skill, care and diligence in carrying out design. Consequently, it will be necessary to establish what type and standard of duty of care is being provided under the warranty.

3.4.6 The warranty should be reviewed to establish whether there are any limitations on the liability of the party giving the warranty. The warranty may seek to include a limitation on the ability of the interested third party to make a claim so that such party can only, in the event of a defect, recover the cost of rectifying and repairing damage directly caused by such defects (thereby excluding other losses, such as loss of profit, rent, etc.).

3.4.7 There may be other limitations on the liability of the warrantor contained within the warranty. The warranty may provide that any limitations or exclusions within the underlying contract (such as a cap on liability) should apply equally to any claim under the warranty. A collateral warranty usually includes a 'no greater liability' and/or an 'equivalent right of defence' clause. These are explained in detail at paragraph 2.4.4(f). As a result of such clauses, it will be necessary to review the terms of the relevant underlying contract as much as the terms of the collateral warranty itself.

3.4.8 Most collateral warranties will include a clause limiting the period during which the beneficiary may make a claim against the warrantor. It will be necessary to check what that period is – it is often 12 years from practical completion of the project (although consultants or their advisers might suggest that this period should be 12 years from the date the services have been completed, which may be earlier). Sometimes a period of six years from practical completion (or completion of the services) may be put forward. This needs to be considered in the context of the period within which claims must be made as a matter of law, which is discussed further at paragraph 3.4.14.

3.4.9 Another clause seeking to limit the liability of a warranty is a 'net contribution' clause. This clause is normally worded to the effect that,

where two or more parties involved in the construction project are each jointly liable for the same loss or damage, their liability is limited to an amount which would be apportioned to that party by a court on a 'fair and reasonable' or 'just and equitable' basis. Figure 12 illustrates this concept.

3.4.10 Copyright in the designs, drawings and other materials produced by the warrantor will normally remain with the warrantor. As a result, there will often be a copyright licence in favour of the interested third party beneficiary within a collateral warranty. This is a clause in the warranty granting the beneficiary a licence to use and reproduce the copyrighted materials which have been produced by the warrantor in relation to the project. Are there any limitations to the proposed copyright licence, e.g. is the licence only available if all outstanding costs and fees of the warrantor have been paid? Is the copyright licence irrevocable? Is it royalty-free? The purposes for which the licence may be used will normally be set out (e.g. 'for any purpose related to the Development'). The licence might apply to the use of the documents (e.g. for maintenance purposes) where there is an extension of the development but the rights under the licence may not extend to reproducing the designs contained in the documents for the purposes of building an extension to the development. There may also be a clause which provides that the warrantor will not be liable to the beneficiary for any use to which the documents are put, where that use is for a purpose other than that for which the documents were prepared by the warrantor.

3.4.11 There will usually be a clause in the warranty obliging the warrantor to maintain professional indemnity insurance cover (often for 12 years from practical completion), provided that the warrantor has a design (or management) obligation. These provisions may vary in content and effect and should be examined carefully. It is important to recognise that professional indemnity insurance is renewable annually and is issued on the basis that it covers claims made during the period of insurance. What is the level of professional indemnity insurance cover required by the warranty? It will probably be at the level stated in the underlying contract. Is the amount

sufficient for the purposes of the project? This question is an extremely difficult one to answer; consideration has to be given to, among other matters, what levels of losses could be incurred if the warrantor was in breach of their underlying contract. The clause in the warranty will usually require evidence of professional indemnity cover to be produced by the warrantor, which may be, for example, a broker's letter showing the extent of cover.

3.4.12 A collateral warranty in favour of a funder includes some important differences from warranties in favour of purchasers and tenants. It is usually entered into by the employer as well as by the warrantor (and the funder). A key difference is the inclusion of a right of step-in. A step-in right allows a funder (or a party nominated by the funder) to take over the employer's role on a project. This would usually be where the employer is in default, which means they are in breach of the terms of the funding agreement, they are insolvent and/or they have not complied with the terms of their professional appointments or building contract. It will be necessary to review the funder warranty in this respect. Does the funder have the right to step into the shoes of the employer, and in what circumstances? When does the funder have to make a decision to exercise such a right? Are there any obligations on the funder exercising step-in rights to make payments, e.g. any payments then outstanding to a warrantor, before they can exercise their step-in rights?

3.4.13 There is likely to be a provision allowing the interested third party beneficiary to assign the benefit of the warranty to another party. In effect, the other party takes on the rights that the original beneficiary had under the warranty. It will be necessary, therefore, to review the assignment provisions, if any, of the warranty. Is the beneficiary entitled to assign the benefit of the warranty without the consent of the warrantor? If so, is this limited to a set number of times? Is the consent of the warrantor required? If consent is not required, does the warrantor have to be notified of any assignment (and is such notification a pre-condition to a valid assignment)? It would be usual to see a provision which seeks to impose a limit on the number of occasions that the

warranty could be assigned by the interested third party beneficiary. This may be because the professional indemnity insurers of the contractor and consultants require such a limitation so they have some idea of the likely extent and duration of the warrantor's potential liability.

3.4.14 It will be necessary to check how the warranty is executed and whether that execution is valid. Does the document state that it is to be executed as a deed? If so, check that the document has been executed correctly. Is it to be signed as a simple contract, under hand? If so, is there consideration on the face of the warranty, e.g. that a payment is being made by the beneficiary to the warrantor in consideration of the warrantor entering into the warranty? This may be a nominal payment, for example £10. The basis on which the warranty is to be executed is important. Firstly, where the warranty is to be signed under hand as a simple contract, the warranty must provide for consideration. Further, as a general principle, warranties signed under hand are subject to a six year period of limitation of action (i.e. legal proceedings have to be instituted within six years of the breach complained of), whereas warranties executed as a deed are subject to a 12 year limitation period. Clearly, those receiving warranties will usually be looking for a 12 year limitation period. This needs to be looked at in the context of any express provision within the warranty, which provides that the interested third party beneficiary has to commence proceedings against the warrantor within a set period of time (see paragraph 3.4.8).

3.5 Third party rights – items for consideration

3.5.1 Third party rights are rights provided for under the TPR Act which allow an interested third party beneficiary to enforce the terms of a building contract, sub-contract or consultant appointment, that otherwise the third party could not enforce against the contractor, sub-contractor or consultant because the beneficiary is not a party to that contract. Such

rights can, therefore, create a contractual relationship in the same manner as collateral warranties. This is explained in greater detail at paragraph 1.1.5.

3.5.2 In general, third party rights will be provided to the interested third party beneficiaries to whom collateral warranties would otherwise be provided. Therefore, the comments made in paragraph 3.4, in relation to warranties, generally apply to any third party rights being offered to an interested third party.

3.5.3 Parties drawing up relevant contracts will want to consider whether to provide for collateral warranties alone or third party rights alone, or to retain the flexibility of being able to procure both collateral warranties and third party rights in favour of interested third party beneficiaries (albeit that such beneficiaries can only receive one or other of them, not both).

3.5.4 Third party rights are now more commonplace in development projects and, indeed, are specifically provided for in certain standard forms of contract, such as those published by the JCT. Using third party rights may help reduce paperwork and save time on construction projects, because separate collateral warranty documents do not need to be negotiated, executed and returned. Delays and additional expenditure should, therefore, be avoided. However, certain interested third party beneficiaries may still be reluctant to accept third party rights instead of receiving hard copy, signed and dated, collateral warranties.

3.5.5 The requirement to provide third party rights, and the terms of such rights, will be set out in the underlying contracts (i.e. the building contract, sub-contracts and appointments). It is essential that, if required, a third party is given effective third party rights, i.e. rights that are enforceable and on which the third party can rely. If a collateral warranty is properly completed, an interested third party who wishes to claim under it will look at the terms of the collateral warranty. If an interested third party is relying on third party rights, the contractor, sub-contractor or consultant will seek to establish whether that third party actually has the right to enforce the relevant provisions of the underlying contract.

3.5.6 It will be necessary, therefore, to examine how such third party rights are given in favour of interested third party beneficiaries. If third party rights are provided for, there must be a mechanism within the relevant underlying contract for such third party rights to be given to a beneficiary. For example, the third party must have been sufficiently identified within the relevant underlying contract.

3.5.7 Most underlying contracts will identify the third party rights to be given to a beneficiary either by including them within a standalone schedule or by a schedule identifying the clauses that a third party may enforce. The means by which such rights become effective pursuant to the underlying contract also need to be reviewed. This is often by means of a notice (in a prescribed form) being sent by the employer to the relevant party giving the third party rights (i.e. the contractor, sub-contractor or consultant). The operative clause may refer to more than one schedule of rights for different classes of third party, e.g. there is likely to be one schedule for purchasers and tenants and one schedule for funders (just as there are likely to be separate collateral warranties in favour of purchasers and tenants on the one hand, and funders, on the other).

3.5.8 The relevant statute (the TPR Act) which enables third party rights to be given also prevents the parties to the underlying contract rescinding or varying the contract if third party rights have been given. Therefore, the parties to the underlying contract often reserve the right to rescind or vary the contract without reference to a third party benefitting from third party rights.

3.6 Collateral warranties/third party rights and latent defects insurance

In the context of collateral warranties and third party rights, it is relevant to mention latent defects insurance policies (sometimes also referred to as decennial insurance policies as they tend to cover a building against defects for ten years from practical completion). It is not possible, within this guidance note, to

review all the insurance policy options available but, in essence, a latent defects insurance policy is a non-cancellable policy covering the cost of rectifying certain types of defects that may arise in a building during a ten (or sometimes 12) year period following practical completion. It would tend to cover, as insured, owners, tenants and certain other parties with an interest in the project (including funders). Such a policy is often put forward as an alternative to collateral warranties and third party rights and the terms (and cost) of the policy would have to be examined closely by insurance specialists. However, even where a latent defects insurance policy is in place, it is often the case that collateral warranties and third party rights are still needed to cover any gaps that there may be in the extent of cover provided.

3.7 Direct agreements – items for consideration

3.7.1 Direct agreements are used mainly in public sector projects, such as PFI/PPP, but they are sometimes used in more complex property development and other major projects involving a government body. It will be necessary to establish in what circumstances the funder can step into the shoes of the employer. Consideration should be given to what the events of default in the contract are, and to what extent the employer is at risk of defaulting under the contract.

3.7.2 What power does the funder have once the step in has occurred? For example, do they have the power to administer the building contract/sub-contract (or other relevant contract) themselves, or solely to appoint another entity to do so?

3.7.3 Consideration should also be given to how long the funder has to find a replacement body, and what the specified standard is that the funder should follow when finding such a body. For example, does the funder have to find a body with the same financial and, perhaps, technical standing as the original employer? Should any such body have experience of running similar projects? The

direct agreement will have a step in period, which is the time given to the funder to assess whether it is worth rescuing the project through transferring the project by novation to another body the funder controls or has an interest in. Consideration has to be given to how long this period should be (e.g. 90-120 days is not uncommon in some PFI/PPP projects) and to whether the contractor is paid during this period. It will normally be a condition to any exercise of a step-in right that the funder undertakes to pay any amounts that are unpaid at the time the step-in rights are exercised and to discharge any future obligations owed to the contractor which arise after that date during the step in period or after the contract has been formally taken over. The direct agreement will usually specify the grounds on which the contractor can object to a proposed replacement employer. The contractor will need to know that the proposed replacement has sufficient capacity (including financial resources) to perform the obligations arising under the contract.

3.8 Payment security methods – items for consideration

3.8.1 Escrow accounts

(a) An escrow account is sometimes used in a construction project as security for payments which an employer is to make to a contractor under a building contract. This is because such payments are generally made in arrears.

(b) A contractor may be concerned about the ability of the employer to make such payments and/or with its ability to recover unpaid amounts from the employer (e.g. because the employer is not resident or has no assets within the UK).

(c) It will be necessary to review the status of the bank account into which escrow monies are paid. Is the account in the joint names of the employer and the contractor? Is it in the names of their lawyers (who might operate the escrow account as escrow agents on their behalf)?

(d) How much is to be paid into the escrow account and when are such payments to be

made? On a project that will take some time to complete, the parties may need to agree that the sum in the escrow can vary over time, either to reflect the highest likely payment level or to reflect the reducing costs of the project as it nears completion. Alternatively, the escrow account might be used to make all payments under the building contract in which cash payments into the escrow account can reflect an agreed cash flow schedule.

(e) What is the position of the contractor in the event of the insolvency of the employer? Will the contractor have a secured claim against monies in the escrow account or will such monies be in the general pot for the benefit of all creditors of the employer? Are the monies held in the escrow account being held in trust in favour of the contractor? This is a detailed and complex area of law but if such monies are subject to a trust then, in principle, the contractor can call for payment from that account, despite the employer's insolvency. If there is no trust established in favour of the contractor, the contractor is likely to have to prove along with the other creditors of the employer on an equal basis in any insolvency proceedings, to recover any sums owed to it by the insolvent employer. In most cases, where no trust is established, the contractor will rank as an unsecured creditor in the employer's insolvency and may not be able to recover all or any of their debt.

(f) There are likely to be a series of documents in place dealing with the escrow account and the manner in which funds can be paid out of such escrow account. These may consist of a contract that formalises the escrow arrangements between the parties and a contract with the party who is to operate the account – the escrow agent. The terms on which the escrow agent will operate the account will need to be reviewed carefully. It is likely that the agent will want to operate the account in a 'mechanical' manner, i.e. it will pay out only on receiving notices in the forms contained within the escrow agreement.

Care should be taken to ensure that the notices are served using the correct method, contain the required information and are served on the correct person and address within the

prescribed timescales. These details are usually set out in the escrow agreement in addition to the form of notice which should be used. An amendment to the building contract may be required, adjusting the payment terms to take account of payments coming from the escrow account or the possibility that some payments may come from the escrow account. There are likely to be provisions dealing with the cost of any significant change or variation to the works which might alter the cash flow schedule and require an adjustment to the sum being held in the escrow account.

(g) The escrow arrangements will need to set out clearly how the monies in the escrow account, and any accrued interest, should be paid out in all conceivable circumstances, even if the project is stopped or abandoned. It should also deal with who pays for the cost of running the account and set out how disputes should be dealt with.

(h) In relation to the building contract amendments (if required), there may be further amendments that need to be made depending on the terms of the escrow arrangement. For example, in the event that either party wants to suspend the performance of its obligations under the building contract for non-payment, the building contract may need to be amended so that non-payment into/from the escrow account is also included.

(i) Consideration should also be given to whether the escrow agreement will be considered a construction contract for the purposes of the *Housing Grants, Construction and Regeneration Act 1996* (as amended) (the *Construction Act*) and, therefore, whether its provisions conform to the terms of the Act. The full details and effect of the *Construction Act* are outside the scope of this guidance note but, in general terms, the Act regulates, among other things, how payment provisions must be structured within a qualifying construction contract and provides for disputes to be dealt with by way of adjudication.

3.8.2 Project bank accounts

(a) A project bank account is designed to increase payment security and speed up

payment for contractors and others in the construction supply chain.

(b) In a typical example of a construction project, the parties set up a project bank account in the joint names of the employer and the contractor. The intention is to adopt a payment mechanism under which parties in the supply chain (including sub-contractors) receive payment through a bank account operated in accordance with the terms of an agreement between the relevant parties.

(c) The building contract should set out the sums that the employer has to pay into the project bank account. Those payments should be made as and when such monies become due in accordance with the terms of the building contract. The intention is that the contractor, sub-contractors and suppliers who are parties to the project bank account agreement are all paid on time and in accordance with their relevant contracts.

(d) There is likely to be a restriction on the ability of the account holders (who are likely to be the employer and the main contractor) to withdraw monies from the project bank account (other than in the case of monies properly owed to the contractor). The monies are usually held in trust for the benefit of the supply chain in accordance with their contractual entitlements.

(e) It would be common in project bank account arrangements to have regular (usually monthly) payments made into the account. The account then reduces/empties as payments are authorised to be made to the contractor, sub-contractors and suppliers.

(f) If an employer needs to pay less than the amount otherwise owing to the contractor under the building contract, they should issue the appropriate notices required under the contract in the usual way. Care should be taken to ensure that the notices are served using the correct method, contain the required information and are served on the correct person and address, and within the prescribed timescales. These details are usually set out in the building contract (or, if not set out there, are usually prescribed by default by the *Construction Act*). Project bank accounts do

not cut across existing contractual or statutory obligations or entitlements.

(g) As and when new sub-contractors are appointed by a contractor after the date of any project bank account agreement, and it is agreed that such sub-contractor should be an additional party, it will be necessary to document that position. This will usually be by way of a simple 'additional party' deed. Similarly, if a sub-contractor is removed or ceases to be involved, that sub-contractor should cease to have any further interest in the project bank account.

(h) The relevant project bank account agreement should be reviewed to establish whether the benefit of the agreement is assignable by any of the parties to another party.

(i) Consideration should be given to when the project bank account agreement terminates and in what circumstances. Is the agreement live until all payments have been made under the project contracts; will it determine if the employment of the contractor under the building contract determines; can the parties agree that it determines, and so on?

(j) Establish the position on interest payable on the amounts deposited in a project bank account. Who takes the benefit of such interest

and in what circumstances? Often the interest can be used to offset bank charges.

(k) The list of sub-contractors who will take the benefit of a project bank account arrangement will have to be agreed for inclusion in the building contract (having regard to the mechanism for adding sub-contractors referred to at 3.8.2(g)).

(l) As discussed at paragraph 3.8.1(e), in the context of a creation of a trust over monies in an escrow account, similar principles apply in relation to a project bank account. In short, while this is a complex area, if the balance of a project bank account is subject to a trust in favour of the contractor and sub-contractors then, in principle, the contractor and sub-contractors can call for payment from that account despite the insolvency of the employer. This should mean that the contractor's and sub-contractors' claims in such an insolvency will be over the amounts owed to them under the building contract and sub-contracts (or pro-rata if there are insufficient monies to pay them all within the account) and these claims should rank in 'priority' to claims from unsecured creditors of the employer.

(m) Both the JCT and NEC publish project bank account materials for use with their respective contracts.

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