How to choose the right type of security for your contract

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Setting on a specific type of security during contractual negotiations is not as easy as it sounds. It is like having to choose dessert before the dinner has even started. You might want to make a safe choice in case you arrive hungry at the end of the meal, or you might not want to invest too much in case you end up not eating it at all.
Strategic choices must be made, and the person negotiating the terms of an agreement (just like the person who must decide early on its dessert) must consider all possible implications of the choices that they are early subscribing to. That is not an easy task.

The skills of knowing what to look for and what to avoid when it comes to contractual negotiations usually come from experience, meaning that one is likely to learn what works and what does not work only once they have tried it a fair number of times and seen the results.

This article gives you a shortcut, telling the advantages and problems that one might face when going for one or another type of dessert, or performance bond if you wish. Ultimately, all we can offer is to present you with the facts, the upsides and downsides of your options. The choice of the most convenient alternative (as well as the responsibility to deal with the aftertaste of your choice) remains completely yours.

Providing for Securities

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A typical negotiation of a construction contract or subcontract does not leave much room to the option of not putting a security in place. A security is a separate contract with which the principal (*ie.* the contractor or subcontractor) provides financial assurance to the beneficiary (*ie.* the employer of main contractor) of a due and proper performance of its obligations. Such financial assurance is provided by means of binding a payer (*ie.* a bank, an insurer, or the parent company) to the payment of a sum upon the fulfilment of certain requirements. Technically speaking, the most common forms of securities are bonds and guarantees.
Practically speaking, the names do us no good as nomenclature is often mixed and nondescriptive.

Demand Bonds (or on-demand bonds)

To organize the ideas hereby presented, it is important to give a name to the securities we are about to discuss. And here I will talk about Demand Bonds. I cannot, however, emphasize enough that you might encounter this type of security under a completely different name, just as you might see something called a bond which has nothing to do with the type of security I discuss here. Caution and attention to the features of the security (instead of just its name) are essential.

Concept: What I am here calling Demand Bonds are an unconditional and irrevocable guarantees that are autonomous and independent from the underlying contract where performance is disciplined.

Features: As the description above suggests, one of the main features of this type of security is that it forms an autonomous agreement from the contract signed between the parties and upon which the guarantee is made.
As one can imagine, the autonomy of such security implies the construction of a completely different legal framework in its respect. Namely, a different applicable law, a different choice of jurisdiction, and in theory a complete detachment from the terms of the contract.

Also as suggested by the name of the security itself, payment of this bond (also referred to as the “calling” of the bond) is conditioned to the mere presentation of documents. Most commonly, a declaration of the beneficiary that the principal has breached its obligations and a “demand” for payment. In simpler words, payment is made “on demand” without the need to prove entitlement nor solve any dispute.
In the international framework, this type of security is often governed by the ICC Uniform Rules for Demand Guarantees (URDG), which provide standard and harmonized terms accepted and implemented worldwide in relation to the creation, execution and calling of Demand Bonds.

Pros and Cons: Against the above summarized framework, the Demand Bonds has as one of its great benefits the fact that it does not require much for the beneficiary to obtain payment. More security for the beneficiary can also mean further room to negotiate the price in favour of the principal.
Another great advantage is the consolidated international framework of rules in which this type of security is contained. The fact that Demand Bonds are consistently governed by the ICC URDG gives a lot of predictability to the mechanism. Regardless of the legal background of the parties and of their preferences and habits, the rules are the same everywhere. In that sense, art. 34 and 35 of the ICC URDG provide that:

“Article 34. Governing law
a. Unless otherwise provided in the guarantee, its governing law shall be that of the location of the guarantor's branch or office that issued the guarantee.
b. Unless otherwise provided in the counter-guarantee, its governing law shall be that of the location of the counter-guarantor's branch or office that issued the counter-guarantee.

Article 35. Jurisdiction
a. Unless otherwise provided in the guarantee, any dispute between the guarantor and the beneficiary relating to the guarantee shall be settled exclusively by the competent court of the country of

the location of the guarantor's branch or office that issued the guarantee.
b. Unless otherwise provided in the counter-guarantee, any dispute between the counterguarantor and the guarantor relating to the counter-guarantee shall be settled exclusively by the competent court of the country of the location of the counter-guarantor's branch or office that issued the counter-guarantee."

At the same time, in case the principal finds that the beneficiary is calling the bond inadvertently, the framework of on-demand bonds does not leave much room for manoeuvre.
That is because, being the payment based on a simple "demand", no objections to said payment are allowed on the basis of the underlying contract. That does not mean that there is no room for the principal to object to the payment, but the room is certainly very narrow. Having the payment of this type of security blocked requires obtaining an injunction from National Courts.
The requirements for obtaining such type of relief, therefore, will be contained in the applicable law to the demand guarantee, as well as in the procedural requirements for obtaining relief before a specific national legal system.

While most of the systems have extremely narrow approaches as to exceptions that allows for blocking payment of an on-demand bond, it is also true that most exceptions generally cover cases of fraud.

Identifiable elements: as discussed above, the name of the security - in itself - might not be enough to help you characterize it and understand its applicable legal framework. In the case of the security that I am here calling "on-demand bonds", these are the words that you should look out for: "on first demand", "without objections", "unconditionally" or "notwithstanding any objections from the Contractor". Whenever those type of words are present in the terms being negotiated, an on-demand Bond is about to be put in place.

Performance Guarantees

This is the second type of security discussed in this article. Once again, you might encounter what I hereby call performance guarantee by a different name, so let us focus for now on the characteristics of this particular tool.

Concept: within the context of this article, Performance Guarantees are dependent and non-autonomous type of securities to guarantee payment in case liability arises from a specific contractual relationship.

Features: Differently from the on-demand bonds, the Performance Guarantees are a much less "automatic" method of guarantee. In essence, they consist in a contract binding a third party to pay the beneficiary the amount agreed in case of liability of the principal.
The key element to be considered here is the term *liability*. That is because the liability which triggers the payment of the security cannot be grounded on the basis opinion of the beneficiary, but it has to be factually (and sometimes legally) established.
Because intrinsically connected, and thus dependent, on the underlying contract of the main contractual obligation, performance guarantees are usually contained within the framework of the parties' main agreement itself. That means same governing law, same method for dispute resolution and so on. There are no unifying international codes for regulating this specific type of security, meaning they usually just take the form and essence of the terms provided by the frameworks of national laws.

Pros and Cons: One of the great features of the performance guarantee is the assurance that it provides to the principal, which will be able to avoid payment of this type of security until the existence of liability if finally proved. In other words, in case of a dispute of the parties regarding the liability for a certain event (which we know as practitioners that is often the case), payment will be conditioned to a determination of the court/arbitral tribunal with regard to the liability.
Another benefit of this specific type of guarantee is the fact that it is so intrinsically connected to the agreement

itself that it can almost be treated, disputed and contested all within the context of the main dispute. No need to resource to interim relief injunctions, to have proceedings going before different national courts, or parallelly before national courts and arbitral tribunals, nothing of the sort. One dispute, one adjudicator and one forum would suffice to cover it all.

On the other side of sword, this type of security provides for a slower process of payment of guarantee, a more complex and uncertain mechanism which might not work in favour of the beneficiary. Because the payment in this case is attached to the resolution of the merits of an eventual dispute, the assurance that the beneficiary has of being paid when needed (as, for instance, in face of a claim vis-à-vis the main client) is far more distant.

Identifiable elements: there is no specific rules as to what performance guarantees can be called and the best way to make sure that you are in front of one is to guarantee that none of the element mentioned above for on-demand bonds are present. In essence, what you will find here is a third-party guaranteeing payment upon a “determination of liability” or a “final decision on the liability” or even “when a party is charged with” something.

How to choose

That is the million-dollar question.

The answer will clearly depend on the interests of your client and on the consideration of all possible outcomes in case of an eventual dispute.

As a rule, beneficiaries tend to push for an on-demand bond while principals tend to prefer performance guarantees. Preferences and favourites, however, may play a little role in the negotiation table depending on the bargaining power of each party.

There is no doubt, however, that given the features and pros and cons of each option, the choice can certainly influence on the negotiated price.

The weight of the choice may also be minimized depending on the applicable law and forum choice of the parties. For instance, even if parties choose for an on-demand bond, they can certainly mitigate the difficulties of disputing said bond by choosing a specific governing law and jurisdiction forum that is similar (if not the same) of those of the main contract. That would certainly help mitigate the risk of conflicting decisions.

In summary, there should be no surprise if the answer to the question “which type of security should I choose?” is “it depends”. It is up to the negotiating party to understand on which elements they are willing to concede, which they simply cannot waive and how to translate those interests into a functioning mechanism of security which will guarantee payment to the beneficiary in accordance with the parties’ intention.

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