Avoiding performance security pitfalls with the FIDIC Silver Book

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Contributor

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The FIDIC Silver Book (2017, as amended) is a set of general conditions drafted by the International Federation of Consulting Engineers (commonly known as FIDIC), which is most appropriately used for an engineering, procurement and construction (EPC) or turnkey project. In such projects, the contractor is engaged to carry out the EPC activities. Under this approach, performance risk is generally allocated to the contractor.

Which forms of security are contemplated under the Silver Book regime?

The Silver Book provides examples of various types of security in its forms, which largely adopt the Uniform Rules of the International Chamber of Commerce. These include examples of a parent company guarantee, tender security and performance security, via a demand guarantee or surety bond. While useful in establishing a general framework, it is ultimately for the parties to negotiate which forms of security will be provided and on what terms.

Performance security and defects

Employers will desire appropriate coverage and quick recourse when it comes to performance security. Conversely, contractors often seek a position that aligns coverage with liability, and indeed seek to ensure any performance security coverage reduces over the life of the project. Negotiation over the defects liability period is often tied closely to performance security requirements.

Under the Silver Book regime, the defect notification period begins when a project is 'taken over' by the employer (sub-clauses 10 and 11). During this time, the employer has the right to notify the contractor of defects that arise as the project begins operation, which the contractor is obliged to remedy.

Under sub-clauses 11.4 and 4.2.2, should a contractor fail to remedy a defect during the defects notification period, or as required by the Taking-Over Certificate, which is issued upon taking over, the employer will have certain options on how to proceed. These include, *inter alia*:

1. carrying out the work itself or having the work carried out by others (including any retesting), in the manner required under the contract and at the contractor's cost, and for which the employer shall be entitled to costs reasonably incurred in remedying the defect or damage;
2. accepting the defective work and either seeking payment of performance damages or a reduction in the contract price;
3. treating that part of the works which cannot be used for its intended purpose by reason of this failure as an omission, as if such omission had been instructed as a variation by instruction; or
4. terminating the contract if the defect or damage deprives the employer of substantially the whole benefit of the works.

Calling upon performance security can be an effective way for an employer to obtain quick recourse to funds for the contractor's failure. However, such a call is often only made in the most serious situations, and likely when the relationship between the contractor and employer has perhaps become frayed.

Points to consider when negotiating performance security

An employer will typically insist upon an on-demand bond lasting for the duration of the defects notification period. On-demand instruments are a very strict form of performance security. There are very few grounds upon which a provider can refuse to pay out, including failure to comply with the precise terms of the bond or illegality, but these will depend on the exact terms of the bond.

In contrast, a surety bond or guarantee will typically require the employer to provide proof of contractor default, which places a higher burden of proof on an employer.

Parties may want to consider the following:

- What is the burden of proof and who has to meet it?
- What conditions should be attributed to the proof of contractor default, eg, must a notification be given to the security provider in writing, to a specific address?
- What is the expiration for the security? Is the contractor required to extend or replace the security if it is due to expire before the end of the period required in the contract? What happens if the contractor fails to do so?
- Who are the parties affected by the terms of the security? Is the security being provided by an appropriate financial institution, in favour of the correct company?

Sub-clause 4.2 of the Silver Book sets out further parameters of performance security, which both parties should consider:

- The instrument chosen should specify the amount and currency used to secure the contractor's performance obligations. These details must be replicated in the 'contract data' of the contract.
- The instrument also needs to be in the same form as that appended to the contract. Therefore, it is prudent to seek advice from legal representatives as to the most appropriate form to use for your particular project. It is also prudent to seek advice from the issuing bank during the negotiation phase, if any terms depart from industry norms.
- Is the 28-day window for providing the security specified in sub-clause 4.2.1 achievable?
- The Silver Book provides that whenever there is an adjustment to the scope of works that results in an overall contract price increase or decrease of more than 20 per cent, the performance security shall increase or decrease correspondingly (sub-clause 4.2.1). The parties should agree on a particular procedure to accommodate this, such as the timeframe in which the security instrument needs to be updated.