

Parent company guarantees in the construction business:

Quite some misunderstandings

The principal concern of a client on a construction project is to ascertain that the works are fully performed. In the event the principal doubts the capability of the contractor by itself so to do, it may be negotiated that the contractor has issued by its controlling company an undertaking that all the necessary resources shall be provided towards the completion of the works and that the whole enterprise to which the contractor belongs is committed to ensuring full performance.

This kind of undertaking is then called a parent company guarantee (PCG).

The term PCG, from a legal point of view, is often wrongly used.

Parent Company?

The parent company of a contractor in reality may not be the entity that owns and/or has available all the technical or human resources that are needed to secure the client. Equipment, labor, etc. may be present with an affiliated company that is not the parent. In the circumstances it may be decided to have the PCG issued by such affiliated company rather than the parent.

Also, the contractor's parent company may be but one in a chain of corporations. It is better to have the PCG issued by the entity that ultimately is in control. Only such ultimate affiliate can achieve that all the resources of the group, as and when necessary, are devoted towards the completion of the works.

A bond rather than a guarantee.

The person that issues a guarantee is legally defined as guarantor. At law, a guarantee is an undertaking that stands by itself. Whether or not the guarantor is liable under a guarantee depends exclusively on the text of the guarantee itself and not on any other document.

The alternative for a guarantee is a bond. The person that issues a bond is legally defined as surety. Whether or not the surety is liable under a bond is determined by reference not only to the text of the bond, but also to the contract between the contractor and the client. Thus it said that the contract – as amended or varied from time to time - is deemed to be fully incorporated into and to form part of the bond.

This means that under a bond all defenses, remedies, cross claims, counter-claims and other rights and entitlements to relief which the contractor may have against the client under the contract, shall equally be available to the surety.

From the perspective of the company that is willing to issue a PCG in order to secure a contractor's performance, it is not intended that the PCG stands by itself. Instead it is wished that the liability of the PCG issuer is accessory to the liability of the contractor.

E.g. the scenario where the contractor has not been paid for several months. After having given all due notices, terminates the contract and leaves site. If thereafter the client makes a call on the PCG, the issuer thereof will not want to be held liable. He will want automatically to be excused by application of the transparency principle.

Thus he will insist to phrase the text of the PCG in the format of a bond according to which he will only be held liable when a default of the contractor is established.

Generally a default by the contractor that triggers the PCG will be deemed at hand in two circumstances.

Firstly, upon the issuance of a certificate of default by a third party if the text of the PCG so provides. Such third party may be an architect, an engineer, a quality controller, a dispute adjudicator or any other pre-arbitral/court referee. Secondly, by the final judgment, order or award of a court or tribunal of competent jurisdiction.

Other circumstances under which a default may be established can be agreed and written down into the PCG.

A performance rather than a payment security.

Bonds and guarantees are generally issued by banks, bonding and/or insurance companies. These financial businesses do not actually have available the means to step in for a defaulting contractor and complete the works. Therefore, the securities that they issue are phrased as an undertaking to pay a certain sum(s) by way of damages, compensation or other relief up to the guaranteed respectively bonded amount.

The underlying philosophy of a PCG is not in essence the payment of monies. Rather it is intended to secure the due performance and completion of works (with the surety/guarantor only being liable for the payment of certain sums if and when the contractor is likewise liable and up to the same amounts).

Thus, when drafting the text of a PCG it will be wise not to seek too much inspiration in the financial industry.

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