

Bank guarantees: important security instruments in the construction sector

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The insolvency of a construction company during the execution of construction work or during the warranty period entails serious consequences for the investors/clients. The most important security instruments to avoid/reduce the negative effects of a possible insolvency of the construction companies during these particularly critical periods are the bank guarantees to be provided by the contractor.

Bank guarantees are used to secure the complete course of a construction project. The main bank guarantees used in the construction sector are: (i) the bank guarantee for the refund of the advance payment made, (ii) the contract performance bank guarantee and (iii) the warranty bank guarantee.

In order to fulfil their security purpose, bank guarantees must meet certain conditions.

Bank guarantee for the refund of the advance payment made

In order to avoid financial losses, the investor should make advance payments exclusively on the basis of bank guarantees that ensure repayment of the advance if and to the extent that the contractor should fail to fulfil his obligations concerning the execution of the works on the terms and within the time limits provided for in the contract.

Contract Performance Bank Guarantee

The investor should also contractually agree on the submission of a bank guarantee for the performance of the contract. The value of such a contract performance bank guarantee is usually 10% of the value of the contract; it is placed at the investor's disposal immediately after the contract is signed and covers all claims of the investor arising as a result of the performance of the contract, in particular those in connection with the execution of the contractually agreed services.

Warranty bank guarantee

At the time of the taking over at the completion of the construction works, the contractor should provide the investor with a warranty bank guarantee, which must cover all claims of the investor in connection with the contractor's warranty obligation. The value of a warranty bank guarantee is usually 5% of the contract value.

Important provisions of bank guarantees

Through the guarantees, the bank undertakes to pay the principal upon request. The amounts referred to in the bank guarantees (e.g. in the case of the advance payment bank guarantee, up to the amount of the advance paid by the principal) should be paid within a certain period of time (a few working days) after receipt of the principal's written request for payment and a statement of the contractor's failure to fulfil the contractual obligations, without any further formalities being required and without the bank having to examine the legal position invoked by the principal. Thus,

payment should be made irrespective of the validity and legal effects of the contract and waiving the formulation of any claims, objections or defenses arising from the contract.

Validity of bank guarantees. Possibility of assignment

The bank guarantees for the advance payment and for the performance of the contract shall be valid at least until the date of the taking over at the completion of the works plus a period of time sufficient to cover any delay in the works. The validity of the warranty guarantee should exceed the warranty period by a reasonable time.

In order not to lose the validity of the bank guarantee in the event of the sale of the construction project during the execution of the construction work or during the warranty period, the bank guarantee must provide for the right of the principal to assign his rights under the bank guarantee at any time; the formalities required for this purpose vis-à-vis the issuing bank should be kept to a minimum; in particular, it is important that the bank's consent is not required.

Conclusion

In order to avoid/reduce the negative effects of the insolvency of the contractors, it is highly advisable to negotiate and include in the contractor agreements an obligation for the contractor to provide bank guarantees for the reimbursement of advance payments, for the performance of the contract and for the warranty. In order to fulfil their security purpose, the bank guarantees must contain certain provisions.

In the event of the contractor's inability to pay/insolvency during the execution of the construction work or during the warranty period, the investor is largely protected if the above-mentioned bank guarantees are in place.

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