The Unsettled Concept of Performance Bond in Ethiopia: Practical Problems in Determining the Scope of the Obligee's Right to Compensation

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Abstract

Performance bonds, most of the time, are issued to cover a small percentage of a contract price. When damage occurs, there may be a remaining damage, in excess of the performance bond, that may need to be otherwise accounted for. This raises the question of whether or not it is possible to claim the remaining amount from the principal debtor. In Ethiopia, the Federal Supreme Court Cassation Bench has passed two contradictory decisions. One is found in file number 47004, passed in 2012, which held that performance bonds are suretyship which in effect means that the obligee is entitled to claim full reparation to the stated amount in the performance bond from the issuer/surety, and the remaining from the principal debtor. The second decision is found in file numbers 69797 and 98348 which held that a principal debtor is liable and the obligee is entitled to claim only to the extent of the performance bond. This decision adversely impacts the obligee by limiting the amount of compensation that he may claim from the principal debtor. However, the decisions are contradictory and lack detailed factual and legal analysis. This article, by adopting a doctrinal research approach, examines the law and performance bonds of selected Ethiopian banks and insurance companies in order to see whether a performance bond limits the liability of a principal debtor or not. The article concludes that the limit of liability of a principal debtor and the right of an obligee depends on the terms of the underlying contract. Thus, performance bonds do not limit the liability of a principal debtor towards the obligee.

Keywords: Performance bond, Surety bond, Surety, Issuer, Principal debtor, Obligee

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1. Introduction

A performance bond is a contractual assurance by an "issuer" to an owner, also known as an "obligee," of a project.[1] Performance bonds are, most of the time, issued to secure the obligee when the principal debtor (who is usually a contractor, seller or service provider) fails to discharge his obligations under the main contract.[2] The performance bond is, therefore, issued to support the performance of the main contract.

Most big construction contracts, multi-million purchasing agreements, and especially government contracts, involve the utilization of performance bonds. In Ethiopia, in government procurement agreements, it is mandatory to furnish performance bonds.[3] In the private sector, however, such bonds are voluntarily furnished by the parties. Despite the prevalent of use of performance bonds, they are the least governed by Ethiopian law(s). Except for the appearance of the name on few laws, the term performance bond has never been defined in Ethiopia.[4] The absence of clear laws that clarify and govern issues pertaining to performance bonds has made it difficult to answer the question as to whether or not a performance bond limits the liability of a principal debtor towards the obligee or not. Moreover, it is not known what a performance bond is and whether it is different from a suretyship, insurance and other similar contracts.

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[1] Ahmed Hassan and Hamimah Adnan,'The Problems and Abuses of Performance Bond in the Construction Industry', (IOP Conference Series: Earth and Environmental Science, 2018)

[2] Darren A. Prum and Lorilee A. Medders, 'The Bonds That Tie: Will a Performance Bond Require that a Surety Deliver a Certified Green Building?'(2012) 9 Hastings Business Law Journal 5.

[3] Federal Public Procurement Directive, Ministry of Finance and Economic Development (2010). Article 16.25.1states that "[e]xcept for procurements executed by means of request for quotation or procurement of rental services, a Public Body has to require a supplier under contract with it to furnish performance security in any procurement."

[4] It appears in the Federal Public Procurement and Property Administration Proclamation, 2009 Proc. No. 649/2009, Fed. Neg. Gaz., Year 15, No.60; see also the Federal Public Procurement Directive, Ministry of Finance and Economic Development (2010).

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Globally, there are different approaches in naming performance bonds. Some jurisdictions name them as contracts to be governed by the terms they outline, as well as general contract laws.[5] Some of them categorize them as surety while others consider them to be both surety and documentary guarantees like a letter of credit depending on the wording of the performance bond.[6] In Ethiopia, some cassation decisions have labeled performance bonds as surety.[7] Proper characterization of performance bonds helps to determine the applicable law, which should be used to address issues that may arise in relation to them. The primary issue that this paper tries to address is whether or not a performance bond limits the total amount of damages that anobligee may claim from the principal debtor. The answer to this question requires understanding the meaning of a performance bond, and differentiating a guarantee, from an insurance policy.

In order to address the isuue, thus, this article is framed into six parts. The first part gives general introduction about performance bond and related legal issues. The second part highlites the concept of performance bond in general. The third part, under the title types and nature of performance bonds, shows how far a performance bond is similar to or different from surety, an insurance policy and an indemnity agreement. The fourth part deals with the extent of liabilities of an issuer and a principal debtor in a performance bond. The fifth part is about the fate of an obligee who incurred damage greater than the amount for which performance bond is furnished. Finally, the last part offers a conclusion.

2. The Concept of a Performance Bond

A performance bond is a form of security issued to secure the performance of a

[5]Josepf Dalby, 'A Performance Bond, Deconstructed' (2010)11 Bus. L. Int'l105.
[6]ibid
[7] See, for example, Ethiopian Insurance Corporation vs. Bale Rural Development Organization, Volume 13, File Number 47004 (Federal Supreme Court Cassation Bench, 2012).

contract.[8] Surety Association of Canadade fines performance bond as "[a] … bond that guarantees that the bonded contractor will perform its obligations under the contract in accordance with the contract's terms and conditions".[9] It is a common custom that owners, buyers, and employers may require different forms of performance securities to ensure the performance of the contract by their contractors, sellers, or employees respectively. Among the common securities are cash, cheque, insurance, and performance bonds. A performance bond is also a tripartite arrangement whereby one party, X, guarantees the performance of the contractual obligations of another party, Y, to a third party Z. If Y "fails to perform" its obligations under the concerned contract, X is responsible for paying the aforementioned amount to Z.[10] This creates a tripartite relationship between the principal debtor, the obligee, and the issuer.[11]

The purpose of a performance bond is two-fold. First, it provides security for the obligee that the contract will be performed in accordance with its terms and conditions of the contract, and that the issuer will compensate the former when the principal debtor fails to perform its obligations.[12] Secondly, performance bond establishes a third party, issuer, which can verify that the principal debtor is qualified to perform the contract.[13] Issuers such as banks, insurance companies and surety bond companies do not issue a performance bond without evaluating the "three Cs" of the principal debtor: the "Capital", "Capacity" and "Character".[14] The

[8] Maureen D. Carman, *Regulatory and Transactional Bonding: A Primer on Surety Bonding for the Mineral Lawyer* (EMLF, USA, 1997) 235.
[9]Surety Association of Canada<https://www.suretycanada.com/SAC/Surety-Bonds/Contract-Surety/Performance-Bonds/SAC/Surety-Bonds/Performance-Bonds.aspx?hkey=3f931cd0-ada6-4735-9e17-c1fac2ff5f81> accessed on August 25, 2021.
[10] In some jurisdictions, guarantors may takeover the duties of the principal debtor instead of paying money.
[11] Marilyn Klinger et al., *Bond Requirements* (American Bar Association 2017) 270.
[12] Lorena Myers and Fazil T. Najafi, 'Performance Bond Benefit-Cost Analysis' (2011) 3 Journal of Transportation Research Board 1.
[13]Ibid
[14]Ibid

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assumption is that a person who can obtain a performance bond is qualified to perform the contract. However, once a contract is signed and the principal debtor is found to be unable to perform the contract, the obligee will have the chance to recover its damage at least to the extent of the performance bond which is issued by a third party. The performance bond might not, however, be enough to cover the damage that the obligee sustains.

A performance bond is a contract.[15]As such, parties are free to determine the scope and nature of the performance bond, or save for some mandatory provisions of the law. For example, in Ethiopia, the amount of a performance bond as envisaged under the Federal Public Procurement Directive shall be at least 10% of the total contract price.[16] In cases of government procurement contracts, it, thus, means a performance bond to be furnished cannot be less than 10% of the total contract price. As performance bonds are agreements, parties are at liberty to determine the scope of the bond and its validity period. Once the obligations of the main contract are performed, the performance bond is returned to the principal debtor.[17] A performance bond may also be returned if the obligee believes that no damage has been incurred as a result of the principal debtor's non-performance.[18] However, if the principal debtor fails to perform and the performance bond has been called, the issuer will be indemnified by the principal debtor to the extent that it has incurred.[19]

A performance bond is not defined anywhere under Ethiopian laws. The Federal

[15] Lawrence R. Moelmann, et al., the *Law of Performance Bonds* (American Bar Association 2009) 5.

[16]Federal Public Procurement Directive, Ministry of Finance and Economic Development (2010), Article 16.25.2.

[17]Federal Public Procurement Directive, Ministry of Finance and Economic Development (2010).

[18]For example, Article 16.25.4 of the Federal Public Procurement Directive states that "notwithstanding the provision of Article 16.25.3 above, the performance security may be returned to the supplier where the Procurement Endorsing Committee ascertains that the noncompliance of the supplier does not affect the interest of, or entail additional cost on the Public Body and is not due to the fault of the supplier".

[19] Klinger, et al. (n 11) 270.

Public Procurement Proclamation as well as the Directive thereunder use the word "procurement security" and "state performance bond" as a means of performance security.[20] Under these laws, performance security can be provided in the form of cash, a cheque certified by a reputable bank, bank guarantee, letter of credit, conditional insurance bond, or indemnity insurance as the case may require.[21] Small and microenterprises are required to provide a letter of guarantee from the body organizing or overseeing them. Insurance companies may use their reserve in the National Bank as a performance security.[22] Despite the absence of definition and detailed provisions, performance bonds are widely used in Ethiopia. Government projects as well as private transactions demand performance bonds issued by banks or insurance companies. In practice, most construction companies are required to provide performance bonds after they win a bid. Public universities and other institutions also require a performance bond from equipment suppliers.

3. Types and Nature of Performance Bonds

As an extension to the discussion on the concept of a performance bond, this section identifies the two types of performance bonds: the conditional and unconditional bonds. One of the main issues that bruoght a problem of understanding the concept of a performance bond is the inability to differentiate between these two types of performance bonds. A clear understanding of the two would help to know the governing law of each, and answer the questions: what are conditional and unconditional performance bonds? How are they understood in Ethiopia? What are the problems that have arisen from these bonds? How are the problems understood? Is a performance bond a surety bond, an indemnity bond, or an insurance policy?

[20] Federal Public Procurement Directive, Ministry of Finance and Economic Development (2010), Articles 16.25.2 and 16.16.4; 16.25.6
[21] Ibid
[22] Ibid

3.1. Conditional Vs. Unconditional Performance Bonds

Depending on the agreement of the parties, a performance bond could be conditional or unconditional.[23] Conditional bonds are contracts whereby the issuer becomes liable only upon fulfillment of predetermined conditions, such as the default of the principal debtor and/or when the obligee sustains damage. Unconditional or on-demand performance bonds, however, entitle the obligee to call the performance bond without showing default unless the bond is furnished fraudulently.[24] Thus, only a demand by a letter is a sufficient ground to utilize an unconditional performance bond. Although it is sometimes difficult to distinguish an unconditional performance bond from a conditional performance bond due to the vagueness of the language in which they are formulated, the two are different.

Conditional performance bonds are bonds that are dependent on the main contract in order to come to fruition.[25] Under conditional performance bonds, the obligee is required to prove the default of the principal debtor in the main contract to call the performance bond. Moreover, the issuer is not obliged to pay the obligee unless it has become certain that the principal debtor has failed to perform its obligations as per the terms of the main contract. Thus, no payment will be made to the obligee unless the principal debtor admits its default or a court or an arbitration tribunal decides to this effect.[26]

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[23]Supardi, et al., Performance Bond: Conditional or Unconditional, Construction Industry Development Board, 2009,<https://mpra.ub.uni-muenchen.de/34007/1/MPRA_paper_34007.pdf> accessed on 29 March 2021.

[24] Kevin Patrick Mc Guinness, *The Law of Guarantee: A Treatise on Guarantee, Indemnity and Standby Letter of Credit* (Scarborough, Ont. Carswell 1968) 383.

[25]Azizan Bin Supardi, et al., 'Legal Comparison Between Conditional and Unconditional Performance Bond in Malaysian Construction Contract' (2011) 1 International Surveying Research Journal 45.

[26]Ibid

Unconditional performance bonds, on the other hand, are bonds that exist independently from the main contract.[27] They are payable upon demand by the obligee, and do not require proof of default of the principal debtor to call a performance bond.[28] The issuer has no right to refuse payment if the obligee makes any of such demands except in the case of fraud.[29] This does not mean, however, that unconditional performance bonds exclude mention of the main contract to which they are related. They may contain statements indicating the existence of an underlying contract. Therefore, they are characterized primarily by phrases such as "...pay on your first demand", "...guarantee…waiving all rights of objection and defense", "…forthwith pay on demand" and so on.[30] Therefore, these bonds are payable by the issuer irrespective of the fact of performance or non-performance of the principal debtor's obligations up on presenting documents.

In Ethiopia, both conditional and unconditional performance bonds are commonly used, but they have not yet been clearly defined under Ethiopian laws. While performance bonds issued by banks are titled as "unconditional performance bonds" the performance bonds issued by insurance companies are titled as "conditional performance bonds". By law, banks can issue both conditional as well as unconditional performance bonds, but they almost invariably issue the latter. Insurance companies, however, are prohibited from issuing unconditional performance bonds.[31]

[27]Chung-Hsin Hsu, 'The Independence of Demand Guarantees, Performance Bonds and Standby Letters of Credits' (2006) 3 National Taiwan University Law Review 1.
[28]Ibid
[29] Mc Guinness even goes further stating that performance guarantees (unconditional performance bonds) are not guarantees in the legal sense despite their name. See Kevin Patrick Mc Guinness, *The Law of Guarantee: A Treatise on Guarantee, Indemnity and Standby Letter of Credit* (Scarborough, Ont. Carswell 1968) 383.
[30] Template performance bonds issued by banks. Documents on file with the author.
[31]National Bank of Ethiopia, Licensing and Supervision of Insurance Business Directive No. SIB 24/2002.

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Further examining the practice(s) of banks, the contents of unconditional performance bonds issued by the banks are not always the same. Many of the performance bonds issued by banks contain the following: *“…. Bank hereby agree* ***unconditionally*** *and irrevocably to guarantee* ***as a primary obligatory*** *and* ***not as surety merely****, to pay to ….****on its first demandwithout what so ever right of objection on our part*** *and without its first claim to the seller in the amount not exceeding…..”*[32] (Emphasis mine). Other bond issued by banks, however, are stated as: *we----hereby unconditionally undertake to pay you the sum not exceeding ----only* ***upon your simple written demand*** *specifying that customer has failed to perform in accordance with the contracts and if presented to us with the validity time.*[33] (Emphasis mine)

Though these are only two examples of selected performance bonds, from the above clauses, it is clear that a simple demand of the obligee suffices for the bank to effect payment under a performance bond. No objection can be raised by the bank to refuse payment. These are examples of pure unconditional performance bonds. Furthermore, they are considered to be primary obligations -- not mere surety.

Somehow different from the above stipulationis, one performance bond issued by Birhan International Bank reads as follows:*“Birhan International Bank hereby agrees* ***unconditionally*** *and irrevocably to guarantee as* ***primary obligatory*** *and* ***not as surety merely****, to pay to ….****on its first demand without what so ever right of objection on our part*** *and without its first claim to the seller in the amount not exceeding…..”*

[32]Banks’Template Performance Bonds. Document on file with the auhor.
[33]Template Performance Bonds issued by Banks. Document on file with the author.

*Payment of all due herein under will be made to……. **on its written demand accompanied by a certificate signed…. stating that…..has been declared in default for the contract and specifying the total amount due**.*[34](Emphasis mine)

The content in the first paragraph aligns with the previously discussed features of unconditional performance bonds. The paragraph states that it is unconditional and payable on the *first demand* of the obligee. Moreover, it states that payment shall be made "without what so ever right of objection on our part". The second paragraph, however, requires the demand to be accompanied by a certificate stating that the principal debtor has been declared in default. This conveys that payment will not be made unless the principal debtor fails to perform his obligations under the main contract and it is proved through a certificate. It states that the bond is "unconditional" in one sense, and conditional in another sense, as it puts conditions of showing a certificate of default. Then, how does one reconcile to these multiple characteristics?

Unconditional performance bonds are documentary guarantees. They are payable upon demand along with supporting documents in accordance with the terms of the performance bond.[35]Within the constraints of an unconditional performance bond, the obligee is required to strictly comply with the bond but not with any underlying contract.[36] The ICC Uniform Rules for Demand Guarantees indicate that documentary conditions do not change the nature of the guarantee.[37] Non-documentary conditions are prohibited for unconditional guarantees.[38] Unconditional performance bond cannot exist with a non-documentary performance bond. Documentary conditions, however, are possible as long as the issuer of the performance bond can easily determine it from its records. Therefore,

[34]A Performance Bond issued by Birhan International Bank. Document on file with the auhor.
[35]Hsu C. (n 27).
[36] M. Sc, Aleksander Lukich, 'The Role and Importance of Bank Demand Guarantees in International Trade' (2014) 5 Int. J. Eco. Res 1.
[37]International Chamber of Commerce Uniform Rules for Demand Guarantees (URDG), Article 15.
[38] URDG, Article 7.

Birhan International Bank's performance bond, quoted above, can be considered an unconditional performance bond, as the conditions laid down in the bond are documentary.

Furthermore, the National Bank Directive on Financial Guarantee Bond's definition of the unconditional bond helps in understanding the concept. It explains, " [an] unconditional bond is a bond other than financial guarantee issued… that is *payable* to the beneficiary *on demand, without preconditions attached to such payment*".[39] Therefore, on-demand bonds are bonds that are payable upon demand and without preconditions attached to them.

Conditional performance bonds, like the unconditional performance ones, are not clearly defined anywhere in Ethiopian law. However, upon examining the conditional performance bonds issued by insurance companies, it becomes clear that they are bonds payable due to the non-fulfillment of the obligations specified in the underlying contract. A performance bond issued by Nib and Lion Insurance Companies reads as follows:

"…the conditions of the forgoing obligations are such that if the Contractor shall well and truly and faithfully comply with all terms, covenants and conditions of the said contract on its part to be kept and performed accordingly to the tender of the said contract or if in default by the Contractor, the Surety shall satisfy and discharge the damage sustained by the Employer thereby up to birr……."[40] (Emphasis mine)

The issuer becomes liable when the principal debtor fails to discharge the obligations stated under the main contract. Therefore, the issuer/surety is entitled to

[39]Ethiopian National Bank, Licensing and Supervision of Insurance Business Directive No. SIB 24/2004.
[40]Template Performance Bonds issued by Lion Insurance Co. and Nib Insurance Co. Document on file with the author.

raise the defenses available to the principal debtor under the main contract to reject payment of the money stated in the performance bond.[41] It has to be noted that the issuer is described as "surety" in the above performance bonds, while the unconditional performance bonds depict them as "primary obligator and not merely as surety".

3.2. Performance Bond Vs Guarantee/Surety Bonds

"Suretyship is a credit transaction. A surety, by providing bonds to its principal debtor, is, in reality, providing the surety's credit to the principal debtor in order for the principal debtor to enter into a contract with the obligee."[42] Like a performance bond, a surety bond involves three parties: the principal debtor, the creditor and the surety.[43] Determining a performance bond whether it is a surety bond or not would be helpful in identifying the governing law.

All promises to pay or perform the duty of others are not suretyship.[44] It is only when the obligation of the surety emanates from the obligation of the principal debtor towards an obligee that a surety may exist. The question of whether a performance bond is a surety bond or not had reached the Ethiopian Federal Supreme Court Cassation Bench. In two cases, the bench has held that performance bonds are surety bonds.[45] A Brief description of, the commentary on the two decisions is given below:

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[41]Defences that may be raised by the issuer include, but not limited to no default of the principal debtor, obligee has taken actions that prejudice the rights of the issuer, there was a material change to the contract, and so on. See Brian G Lust Bader, 'Performance Bonds: Default, Defences and Discharge' (2012) 87 New York Law Journal246.

[42] George J. Bachrach, 'The Surety's Rights to Obtain Salvage Exoneration, Reimbursement, Subrogation and Contribution' in George J. Bachrach (ed), *Salvage by the Surety* (American Bar Association, 1998).

[43]Ibid

[44] David G.M. Marks, eta al, *Rowalt on the Law of Principal and Surety* (4[th]edn, Sweet & Maxwell, 1982) 1.

[45] See Ethiopian Insurance Corporation v Bale Rural Development Organization, Volume 13, File Number 47004 (Federal Supreme Court Cassation Bench Bench, 2012); ZerihunYeneneh et al v

The case between Ethiopian Insurance Corporation and Bale Rural Development Organization concerns the governing law of performance bonds.[46] The issue was whether or not a performance bond is governed by the insurance provisions of the Commercial Code or the suretyship provisions of the Civil Code. The Cassation Bench held that a performance bond is in fact a surety bond to be governed by the suretyship provisions of the Civil Code. Then, the Bench reasoned four cases: (1) the parties to the bond are described as surety and contractor, and not insurer and insured; (2) as defined in Black's Law dictionary falls under the definition of a surety bond; (3) performance bond involves three parties; and (4) the bond is a conditional bond. The Bench also made a long analysis of how it is different from the insurance which is discussed in the next section of this article.

Although the court did not put considerable emphasis on the conditional nature of the bond, it is one of the most important facts of the case. The author agrees with the final decision of the Bench. Conditional performance bonds are surety bonds to be governed by the suretyship provisions of the Civil Code. Conditional performance bonds like suretyship agreements are secondary obligations, the surety may not be called to perform unless the principal debtor defaults. The parties to the contract are three: the principal debtor, the surety and the obligee. Besides, there are two contracts: the underlying contract between the principal debtor and the obligee, and the performance bond between the three. As a result, conditional performance bonds become surety bonds.

Unconditional performance bonds, on the other hand, may not be surety bonds. This is because unconditional performance bonds, unlike suretyship, put more burdensome obligations on the surety as they forget the benefit of discussion by the surety. Also, in suretyship, the default of the principal debtor is mandatory for the

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Hawassa University, Volume 19, File Number 98348 (Federal Supreme Court Cassation Bench, 2015).

[46]Ethiopian Insurance Corporation v Bale Rural Development Organization, Volume 13, File Number 47004 (Federal Supreme Court Cassation Bench, 2012).

surety to be obliged to cash the performance bond, as it is an accessory contract. Moreover, unconditional performance bonds are different from the joint guarantee stated under Article 1933 of the Ethiopian Civil Code. Article 1933 of the Civil Code states that "where the person undertaking the guarantee described himself as joint guarantor, co-debtor, or used equivalent terms, the creditor may sue him without previously demanding payment from the debtor or realizing his securities". The benefit of discussion given to simple suretyship is taken away in the case of joint guarantee.

The issuers of unconditional performance bonds, who describe themselves as "primary obligators," may fall under the "equivalent term" stated in the above provision. Additionally, both of them waive the benefit of discussion. However, the main feature of the unconditional performance bond distinguishes it from the suretyship. That is to say, in joint guarantee, although the creditor may request payment directly from the guarantor without requesting the principal debtor, the guarantor is liable only when the principal debtor fails to discharge its duties in the agreement[47] and the guarantor is entitled to setup all defenses available to the principal debtor against the oblige.[48] Unlike the joint guarantee, issuers of unconditional performance bonds are liable irrespective of the fact that the principal debtor has defaulted to discharge the obligations in the main contract, and the issuer of the bond cannot setup any defense against the obligee unless it is stated in the performance bond.

To conclude, unconditional performance bonds cannot be considered as surety bonds because they are based on more burdensome terms as they take away the rights of the issuer to setup the defenses available to the principal debtor against the

[47]Civil Code of Ethiopia, 1960, Art. 1933/2 and 1920, Proc. No. 165/1960, Fed. Neg. Gaz. (Extraordinary issue), Year 19, No. 2.
[48]Ibid, Art. 1933/2 and 1926/2.

obligee and cashed on simple demand.[49] Conditional performance bonds, on the other hand, are surety bonds.

3.3. Surety Bonds Limit the Liability of the Surety, Not that of Principal Debtor

Surety contracts and the underlying contracts are governed by different provisions of the Civil Code. Although surety contracts are regulated by suretyship provisions of the Civil Code, the unerlying contracts are regulated by general contract provisions and/or the relevant special contract provisions like sales contracts, construction contracts...etc. A thorough understanding of the liability of the parties also requires knowledge of the nature of the different contracts as well as the laws that govern them.

a. The Surety Bond Contract

Surety bonds are special types of contracts governed by surety contract laws. In Ethiopia, suretyship is governed by Articles 1920 to 1951 of the Civil Code. According to these provisions, suretyship contracts have the following features: First, a suretyship is an accessroy contract in which the surety can be called to perform only when the principal debtor fails to discharge its obligation.[50] Unless the principal debtor fails to discharge its obligations, in accordance with the terms of the main contract, the surety cannot be obliged to effect the guarantee. Even in cases of joint guarantee, where the obligee is entitled to request payment directly

[49] According to Article 1924/1 of the Civil Code, suretyship cannot be contracted on more burdensome terms. A more burdensome term is a term that denies the surety a right or benefit that the principal debtor is entitled to.
[50] Civil Code of Ethiopia, 1960, Art.1920,1934 and 1938, Proc. No. 165/1960, Fed. Neg. Gaz. (Extraordinary issue), Year 19, No. 2.

from the surety, the surety can setup all defenses that emanate from the main contract.[51]

Second, a surety contract shall be expressed and may not be extended beyond its contractual limits.[52] The surety is expected to pay only the amount specified in the contract even though the damage that the obligee sustained may be more than the specified amount. Therefore, a surety contract limits the liability of the surety towards the obligee.[53] Moreover, the maximum limit of liability that the surety may bear according to the surety contract is the initial contract price.[54] Exceptionally, however, the surety may be liable beyond the maximum amount stated in the surety contract for legal costs incurred to bring action against the principal debtor if he had been notified to discharge the debt.[55] Third, surety contracts may be contracted in respect of only part of the underlying contract price.[56] Suretyship does not necessarily guarantee the whole debt of the principal debtor. Moreover, surety contracts may not be contracted on more burdensome terms. In fact, it may be reduced to the primary debt if it is found to be more burdensome.[57] In addition, the surety is released from liability when the main contract is performed.[58] Finally, if surety is discharged from its obligations for what ever reasons, it is left to the obligee to claim from the principal debtor.[59] Therefore, surety bonds limit the liabilities of the surety.

[51]ibid, Art. 1933/2 and 1926/2.
[52]ibid, Art. 1922/2.
[53]ibid, Art. 1922/3. It states that it shall be of no effect unless it specifies the maximum amount to which the guarantee is given.
[54]ibid, Art. 1924/1 and 3 states that the guarantee which exceeds the amount of the debt is reducible to the amount of the primary debt. The exception, as envisaged uner Article 1931 of the Civil Code, is the additional payments for costs if actions brought against the principal debtor provided that he has been sufficiently notified to enable him to forestall them by discharging the debt.
[55]Ibid, Art. 1931.
[56]Ibid, Art. 1924/2.
[57]Ibid, Art. 1924.
[58]Ibid, Art. 1926.
[59]Ibid, Art. 1940.

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b. The Main/Underlying Contract

The underlying contract is the contract entered between the principal debtor and the obligee. The nature of the contract could be construction contract, sales contract, employment contract or loan contract. The contract mainly envisages the rights and duties of both parties penalty in case of failure, and dispute settlement mechanisms. Therefore, it is this contract that indicates the extent of liabilities of both parties.

Thus, an underlying agreement may contain a provision to limit the liability of the parties. It is possible, for example, to agree on terms that limit the liability of the principal debtor only to the extent stated in the performance bond. Alternately, they may state the maximum amount of damage for which the principal debtor may be liable. This is also clearly indicated in Article 1887 of the Civil Code.

In the absence of specific agreement to limit liability, a party may claim compensation for the damage caused to him as a result of non-performance of the contract. Such compensation must be equal to the actual damage which may go beyond the foreseen liability of the principal debtor during the signing of the contract. For example, in a contract of sale, the seller may be obliged to compensate the buyer if the buyer conducts a replacement purchase with a higher price due to the failure of the seller to perform its obligations.[60] Thus, the actual damage determines the liability of the principal debtor unless they expressly agree to limit the damages.[61]

To conclude, terms agreed to in the underlying contract determine the extent to which the principal debtor is legally liable or the obligee is entitled to claim. In other words, the obligee is entitled to claim the amount stated in the performance bond from the issuer, and the remaining damages, if any, from the principal debtor

[60]Ibid, Art. 2363.
[61]Ibid, Art. 1887.

unless the underlying contract specifically limits the liability of the principal debtor only to the amount stated in the performance bond.

3.4. Performance Bond Vs. Insurance Policy

Whether a performance bond is an insurance policy or not is another important issue worth addressing as it carries implications concerning which law(s) is applicable.

A performance bond is different from an insurance policy. First, an insurance contract is a contract between two persons, while a performance bond is among three persons.[62] In a performance bond, the contract is among the obligee, the principal debtor and the issuer. In insurance, the insured and the insurer enter into a contract on the terms that the insured pays premiums and the insurer indemnifies the insured in certain circumstances. Second, the insurer of an insurance policy can expect losses in insurance, while the issuer of a performance bond does not. Third, insurance spreads risks among a pool of insured persons, while a performance bond guarantees such only for a single person. Last, an issuer has a subrogation right against the principal debtor, while the insurer, on the other hand, has no subrogation right against the insured save for some exceptions in case of liability insurance. For instance, the issuer expects no losses, as they are reimbursed by the principal debtor in the case of any loss. Insurance policy, however, does not have any subrogation rights against the insured itself.[63]

[62] The cassation has asserted that an insurance policy is a contract. See Ethiopian Insurance Corporation v. Beninshangul Regional State, Volume 7, File Number 24703 (Federal Supreme Court Cassation Bench, 2007); also, the Insurance Business Proclamation No. 746/2012, Article 2/20 defines an insurance policy as a document evidencing a contract of insurance.

[63] David W. Slaughter, 'Introduction to the Surety's Rights' in Marilyn Klinger, George J Bachrach, and Tracey Lee Haley (eds) The Surety's indemnity Agreement-Law and Practice (American Bar Association 2008).

The Federal Cassation Bench in Volume 13, file number 47004, contains descriptive analyses distinguishing performance bonds from insurance policies.[64] Accordingly, performance bonds are not insurance bonds for the following reasons:

Primarly, the documents referred to in matters concerning insurance are called "policy", and not performance bonds.[65] Secondly, insurance is based on a premium, but premiums are not paid in the case of a performance bond. Thirdly, the terms used to describe the parties are different. In insurance, the contracting parties to the policy are called insurer and insured. In a performance bond, however, they are described as guarantor, contractor, and employer – or are discribed in similar terms. Additionally, insurable interest is a requirement in insurance while it is not required in order to calla performance bond. Finally, the nature of the liability of insurer is different. In a performance bond, the principal debtor and the issuer are jointly and severally liable for the stated amount if the principal debtor fails to discharge its obligation. In insurance, however, the insurer is liable up to the extent stated in the policy.

The Cassation Bench has rightly pointed out the differences betweenan insurance policy and a performance bond. This does not mean, however, that insurance companies do not issue performance bonds. Even in the above case, the performance bond was issued by an insurance company. Only the issuance of unconditional performance bond is prohibited for insurance companies.[66]

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[64]Ethiopian Insurance Corporation v Bale Rural Development Organization, Volume 13, File Number 47004 (Federal Supreme Court Cassation Bench, 2012).

[65]Civil Code of Ethiopia, 1960, Art.1725(b), 1720, 1727, 1719(2), Proc. No. 165/1960, Fed. Neg. Gaz. (Extraordinary issue), Year 19, No. 2; see also Commercial Code of Ethiopia, 1960, Art. 657(1), Proc. No. 166/1960, Neg. Gaz. (Extraordinary Issue), 19, No. 3.

[66]Ethiopian National Bank, Licensing and Supervision of Insurance Business Directive No. SIB24/2002.

3.5. Performance Bond Vs Indemnity Agreement Between the Parties

By indemnity agreement between the parties, the author refers to a separate or built-in agreement that may be made between two parties to indemnify the person who sustained damage as a result of the other party's failure to perform. Such agreements are made between the parties to an underlying contract and they do not involve third parties. Be it a provision included in anunderlying contract or a separate contract, an indemnity agreement is different from a performance bond. While a performance bond is issued by a third party called the issuer, indemnity agreements are not bonds; but they are agreements signed by the parties to an underlying contract. Therefore, a performance bond is not an indemnity agreement.

4. Liabilities of the Issuer and the Principal debtor in a Performance Bond

4.1. Liability of the Issuer

As stated previously, performance bonds are contracts. In a contract, parties are free to determine the extent(s) to which they are liable, save for some mandatory provisions of a law that may limit their rights. They may agree on whether the obligee can call the performance bond unconditionally or not, conditions that the obligee should fulfill in order to call the performance bond, the expiry date of the performance bond, and so on. Apart from these facts, the liability of the issuer of a performance bond is limited to the extent specified in the bond.

In case of conditional performance bonds, the Ethiopian Civil Code mandatorily requires the surety contract to specify the maximum amount to which the guarantee is given.[67] By doing so, it limits the liability of the surety to the specified amount. For instance, in a performance bond issued by Birhan International Bank, it is stated that "…Birhan International Bank as instructed by…agree to

[67]Civil Code of Ethiopia, 1960, Art. 1922(3), Proc. No. 165/1960, Fed. Neg. Gaz. (Extraordinary issue), Year 19, No. 2.

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guarantee……*in the amount not exceeding Birr 333,750.00…*".[68] Therefore, the maximum liability issued by Birhan bank is Birr 333, 750.00. Even in cases where the guaranteed amount bears interest, the guarantor guarantees the interest only within the limits of the maximum amount stated in the performance bond.[69] However, there are certain situations in which the surety may be liable beyond the amount specified in the performance bond. An example is when a surety fails to discharge its obligation while it was sufficiently notified. In this case, the surety may be liable for the costs of any actions brought against the principal debtor.[70]

In an unconditional performance bond, similar to a conditional performance bond, the liability of the issuer is determined by the terms of the bond. If the amount of liability is specified in the bond, the liability of the issuer is limited to the extent specified within the terms of the bond. Unconditional performance bonds are, therefore, documentary guarantees. The issuer guarantees the obligee that he will pay the stated amount to the obligee upon fulfillment of the required documents and/or the obligations of the involved parties outlined in said documents. Therefore, the issuer's liability is to the extent stated in the performance bond.

Like the conditional performance bond, issuers of unconditional performance bonds may be liable beyond the maximum limit if they fail to perform their obligations and/or if an action has been brought against them. In this case, a court may decide on whether the legal costs of the obligee should be covered by the issuer.[71] Therefore, the liability of the issuer of a performance bond is limited to the amount stated in the said bond -- at least in principle.

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[68]Performance Bond issued by Birhan International Bank. Docoment on file with the author.

[69]Civil Code of Ethiopia, 1960, Art. 1930, Proc. No. 165/1960, Fed. Neg. Gaz. (Extraordinary issue), Year 19, No. 2.

[70]Ibid, Art. 1931.

[71]Civil Procedure Code of Ethiopia, 1965, Art.462,Decree. No. 52/1965, Neg. Gaz. (Extraordinary Issue), Year 25, No. 3. According to this provision, it is the power of the court to decide by whom and to what extent the legal costs are to be paid.

4.2.The Liability of the Principal debtor

The liability of a principal debtor depends on terms and conditions outlined in the underlying contract. The liability of a principal debtor may not be the same in all types of performance bonds. In principle, the principal debtor is liable to the extent of the actual damage that the obligee sustains. The full damage principle is enshrined under Article 1771 and 1790 of the Civil Code. It explains that any damage has to be compensated in an amount equivalent to the damage. However, parties may agree to limit the maximum amount of compensation for which the principal debtor may be liable. Article 1887 of the Civil Code states that "the parties may limit their liability under the contract….". Accordingly, if the parties agree that the principal debtor is liable only to the amount stated in the performance bond that will then be the case.

The Ethiopian Federal Supreme Court Cassation Bench, in file numbers 69797 and 98348, has held that the performance bond is an agreement to limit the liability of a principal debtor.[72]However, the mere fact that the main contract states is that the performance bond will be paid to the obligee if the principal debtor fails to discharge its obligation. This cannot be taken to mean that the principal debtor is liable only to that extent. Therefore, the position of the court is wrong for the following reasons: First, a conditional performance bond is a surety bond that must be governed by the surety provisions. Accordingly, the surety is liable only for amount of the debt stated in the bond which could be less than the total damage caused to the obligee. The principal debtor, however, is liable for the total amount of debt or damage that the obligee sustains due to the failure of the principal debtor to perform its obligations. Second, any agreement to limit liability must be an express agreement. The mere fact the parties state, the performance bond will be

[72] See Mrs. Hilal Suleyman v University of Gondar, Volume 14, File Number 69779 (Federal Supreme Court Cassation Bench, 2012); ZerihunYeneneh et al v Hawassa University, Volume 19, File Number 98348 (Federal Supreme Court Cassation Bench, 2015).

paid to the obligee if the principal debtor fails does not necessarily mean the total amount of damages the obligee may claim is limited to the amount stated in the performance bond. The essence of Article 1887 of the Civil Code is that parties may expressly agree to limit their liabilities.

Concerning an unconditional performance bond, the bond is a documentary guarantee which tells that the issuer will pay the obligee such amount, as specified within the bond itself, upon demand. It is separate from the total amount of liability of the principal debtor. Therefore, the performance bond does not limit the liability of a principal debtor. The liability of the principal debtor is limited by the underlying contract. The extent of liability of a principal debtor is determined by the main contract. The main contract may stipulate that the amount of damage that the obligee may claim from the principal debtor is what is stated in the performance bond. However, a stipulation in the main contract that says, the proceeds of the performance bond shall be paid to the obligee as compensation if the principal debtor fails to discharge its obligations, cannot be understood as a provision limiting the liability of the principal debtor.

In conclusion, unless the main contract stipulates otherwise, the liability of a principal debtor is to the extent of the actual damage that the obligee sustained. Moreover, any provision intended to limit the liability must be express.

5. The Fate of the Obligee who Incurres a Damage Greater than the Amount Stated the Performance Bond

The damage caused to the obligee, on the other hand, may be greater than the amount stated in the performance bond. In this section, therefore, the query whether an obligee may be able to claim beyond the performance bond or not is addressed. As noted previously, an issuer of a performance bond is liable to the amount specified in the performance bond. Therefore, the obligee may call the performance bond to settle some portion of the damage caused to him. The only situation whereby an obligee may claim beyond the performance bond from the issuer is for legal costs.[73] The purpose of performance bond is not to limit the liability of principal debtor in advance. It is rather a means of compensating the obligee if the principal debtor may not have money or property at hand once a dispute arises.

The call for a conditional performance bond by an obligee does not relieve a principal debtor from making good from the actual damage. An obligee may call a performance bond and claim the remaining balance from the principal debtor. Additionally, in an unconditional performance bond, the terms of the contract determine the extent of the obligee's right or the principal debtor's liability. Unless there is an indication of the fact that the principal debtor may not be liable beyond the amount stated in the performance bond, unconditional performance bond does not prohibit the obligee from claiming over the amount stated in the bond.

In Agricom International SA v. Ethiopian Trading Business Corporation (ETBC), the arbitral tribunal awarded the buyer (ETBC) full damages which is more than the stated amount in the performance bond.[74] The seller, Agricom, agreed to supply wheat to the buyer-ETBC but 'failed to do so'. ETBC conducted a purchase in replacement from another seller which resulted in incurring additional cost. Infront of the arbitration panel, Agricom argued that it was liable only to the extent of the performance bond as the contract states that "the proceeds of performance bond shall be payable to the buyer as compensation for any seller's failure to comply with its obligation under the contract". The buyer, on the other hand, citing Article 2362 of the Ethiopian Civil Code, argued that compensation shall be paid for all

[73]Civil Code of Ethiopia, 1960, Art 1931, Proc. No. 165/1960, Fed. Neg. Gaz. (Extraordinary issue), Year 19, No. 2.
[74]Agricom International SA v. Ethiopian Trading Business Corporation, Volume 24, File Number 155880 (Federal Supreme Court Cassation Bench, 2019). The award of the tribunal is attached with, and stated in, the cassation petition.

damage incurred as a result of the purchase in replacement. The tribunal, finally, rejected the argument of the seller, and stated that parties did not agree to limit the liability of the seller to the amount stated in the performance bond.

In a different case, the Cassation Bench, however, held an opposite stand. In the case between Mrs. Hilal Suleyman and University of Gondar, the University conducted a purchase in replacement of bread for students as Mrs. Hilal failed to deliver in accordance with the terms of the contract.[75] As a result, the University incurred additional costs of Birr 1,148,846.40 for the purchase in replacement. This amount is by far greater than the 10% performance bond agreed by the parties which is Birr 245,036.

The Bench held that the purpose of the performance bond is to compensate the University in case Mrs. Hilal fails to perform her obligation that is a compensation agreed upon in advance. For the Bench, such agreement is possible pursuant to Articles 1731 and 1889 of the Civil Code. Accordingly, it decided that payment in accordance with the performance bond is the only compensation that the University may claim from Mrs. Hilal. This means, the Bench misunderstood the concept of performance bond. Performance bonds are not agreements made to limit the liabilities of the principal debtor. In another case, file number 47004, the Bench held that a performance bond is a surety bond. If a performance bond is a surety bond, how could it be understood as an agreement to limit the liability of a principal debtor? The Bench reached the same conclusion in file number 98348.[76] In short, a performance bond is issued for the benefit of the obligee, and not to the principal debtor. It cannot be interpreted as an instrument issued to limit the rights of the obligee as well.

[75]Mrs. Hilal Suleyman v University of Gondar, Volume 14, File Number 69797 (Federal Supreme Court Cassation Bench, 2012).
[76]ZerihunYeneneh et al. v Hawassa University, Volume 19, File Number 98348 (Federal Supreme Court Cassation Bench, 2015).

Conclusion

The concept of a performance bond is not settled in Ethiopia as can be seen from the authoritative decisions of the Federal Supreme Court Cassation Bench. It is not clear what a performance bond is and which law governs it. This makes it difficult to determine the extent of rights of an obligee to claim damages from the principal debtor i.e. whether it is limited to the amount stated in the performance bond or it goes beyond that.

From these observations, the author recommends that a clear law that governs performance bonds must be enacted taking the nature of the performance bonds into consideration. It should be also understood, in the meantime, that a performance bond is either a suretyship contract or a documentary guarantee that indicate the amount of money that the obligee may claim from the issuer of the bond. The bond does not state the total amount of liability of a principal debtor or claim of the obligee against the principal debtor. It is simply an underlying contract that determines the limit of rights of an obligee against the principal debtor.

To conclude, the author has tried to bring the unaddressed issues of performance bond into discussion including the contradicting decisions of the Cassation Bench with the purpose of initiating lawyers to further investigate and understand the concept from the perspectives of Ethiopian laws.

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