

PERFORMANCE BOND: CONDITIONAL OR UNCONDITIONAL

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To my family for their love and support

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ABSTRACT

In construction contracts, a 'performance bond' is a bond taken out by the contractor, usually with a bank or insurance company (in return for payment of a premium), for the benefit of and at the request of the employer, in a stipulated maximum sum of liability and enforceable by the employer in the event of the contractor's default, repudiation or insolvency, as stated by Nigel M Robinson *et. al.* in his book, *Construction Law in Singapore and Malaysia*. He further added that there are two types of performance bonds: *Conditional bond* or *default bond*, whereby the surety accepts 'joint and several' responsibility for the performance of the contractor's obligations under the contract; and *Unconditional bond* or *on-demand bond*, which is a covenant by the surety (usually a bank) to indemnify the employer following contractor's default, subject to stated terms and up to a sum commonly 5% of the main contract sum. However, in Malaysia, for the past 20 years and since the famous case of *Teknik Cekap Sdn Bhd v Public Bank Berhad* [1995] 3 MLJ 449 to the recent *Suharta Development Sdn Bhd v United Overseas Bank (M) Bhd & Anor* [2005] 2 MLJ 762, the question of whether the performance bond in a construction contract is a conditional or an unconditional guarantees is still one of the issues relating to performance bond that has been discussed. Thus, in order to determine the types of performance bond applicable in a contract, a thorough understanding of the content of the bond is required. Therefore, the objective of this research is to determine the phrase(s) in the Performance Bond in a construction contract that determine whether the performance bond is a conditional or unconditional on demand guarantee. In order to achieve this objective, the research was conducted by analyzing relevant court cases. From the findings, it can be concluded that unless an undisputed meaning of the words in the performance bond to make the performance bond to be purely conditional or unconditional 'on-demand' bond, most court interpreted performance bond to be an on-demand performance bond which is only conditional upon the beneficiary asserting the basis of the claim upon the issuer of the bond contending that there has been breach of contract.

ABSTRAK

Di dalam kontrak pembinaan, sesuatu 'bon pelaksanaan' adalah satu bond yang diambil oleh kontraktor, selalunya dengan satu bank atau syarikat insuran (sebagai balasan kepada bayaran premium), untuk faedah dan atas permintaan majikan, mengikut jumlah liability maksimum yang dinyatakan dan dikuatkuasakan oleh majikan di dalam kejadian di mana kemungkiran, keengganan atau kebankrapan kontraktor, seperti dinyatakan oleh Nigel M Robinson *et. al.* di dalam bukunya, *Construction Law in Singapore and Malaysia*. Dia menambah bahawa terdapat dua jenis bon pelaksanaan: *Conditional bond* atau *default bond*, di mana penjamin menerima tanggungjawab 'bersama dan beberapa' untuk pelaksanaan obligasi kontraktor di bawah kontrak; dan *Unconditional bond* atau *on-demand bond*, iaitu permuafakatan oleh penjamin (selalunya bank) untuk menggantirugi majikan atas kemungkiran kontraktor, tertakluk kepada syarat-syarat dan kepada jumlah harga biasanya 5% daripada harga kontrak utama. Akan tetapi, di Malaysia, selama 20 tahun sejak kes *Teknik Cekap Sdn Bhd v Public Bank Berhad* [1995] 3 MLJ 449 kepada *Suharta Development Sdn Bhd v United Overseas Bank (M) Bhd & Anor* [2005] 2 MLJ 762, persoalan samada bon pelaksanaan di dalam kontrak pembinaan adalah jaminan bersyarat atau tidak, masih salah satu masalah yang diperbincangkan. Oleh itu, untuk menentukan jenis bon pelaksanaan yang digunakan di dalam kontrak, pengetahuan mendalam kandungan bon tersebut adalah diperlukan. Oleh sebab itu, objektif kajian ini adalah untuk menentukan frasa atau frasa-frasa dalam bon pelaksanaan di dalam kontrak pembinaan yang menentukan samada bon pelaksanaan tersebut adalah jaminan bersyarat atau tidak. Untuk mencapai objektif ini, kajian dijalankan dengan menganalisa kes-kes mahkamah yang relevan. Dari keputusannya, kesimpulan boleh dibuat bahawa kecuali makna perkataan-perkataan bon pelaksanaan adalah bersyarat tulen atau tidak bersyarat tulen, kebanyakan mahkamah mentafsir bon pelaksanaan adalah bon pelaksanaan tidak bersyarat di mana syaratnya hanyalah pada waris menuntut hak dengan mengemukakan tuntutan terhadap bon beralasan bahawa terdapat pelanggaran kontrak.

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LIST OF ABBREVIATIONS

AC	Law Reports: Appeal Cases
All ER	All England Law Reports
AMR	All Malaysia Reports
App Cas	Appeal Cases
Build LR	Building Law Reports
CLJ	Current Law Journal (Malaysia)
EWCA Civ	Court of Appeal, Civil Division (England & Wales)
HL	House of Lords
Lloyd's Rep	Lloyd's List Reports
LR	Law Reports
MLJ	Malayan Law Journal
PC	Privy Council
QB	Queen Bench
SCR	Session Cases Report
SLR	Singapore Law Report
WLR	Weekly Law Report

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CHAPTER 1

INTRODUCTION

1.1 Background of Topic

A performance bond is a bond giving security for the carrying out of a contract, where a bond is a deed by which one person (the obligator) commits himself to another (the obligee) to do something or refrain from doing something.¹ In construction contracts, a 'performance bond' is a bond taken out by the contractor, usually with a bank or insurance company (in return for payment of a premium), for the benefit of and at the request of the employer, in a stipulated maximum sum of liability and enforceable by the employer in the event of the contractor's default, repudiation or insolvency.² These relationships can be illustrated in Figure 1.1.

In Malaysia, most of the need of a performance bond is made through an agreement between the Government, the contractor and a third party (usually a bank or insurance company), whereby the third party agrees to pay a sum of money to the Government, in the event of non-performance of the construction contract by the

¹ Elizabeth A. Martin (2003), *A Dictionary of Law*, 5th Edition reissued with new covers, Oxford University Press, Oxford, p.53

² Nigel M. Robinson et. al. (1996), *Construction Law in Singapore and Malaysia*, 2nd Edition, Butterworths Asia, Singapore, p.205

contractor.³ It is provided in Clause 37(a) of the *P.W.D. Form 203A (Rev. 10/83) Standard Form of Contract to be Used Where Bills of Quantities Form Part of the Contract* that the Contractor shall either deposit with the Government a performance bond in cash or alternatively by way of a Treasury's Deposit or Banker's Draft or approved Banker's or Insurance Guarantee equal to 5% of the Contract Sum as a condition precedent to the commencement of work. In other words, the Contractor is not permitted to carry out any work under the Contract unless and until the performance bond is given. The failure of the Contractor to give the performance bond may amount to a fundamental breach of contract entitling the Government to discharge the Contract and sue the Contractor for damages accordingly.⁴

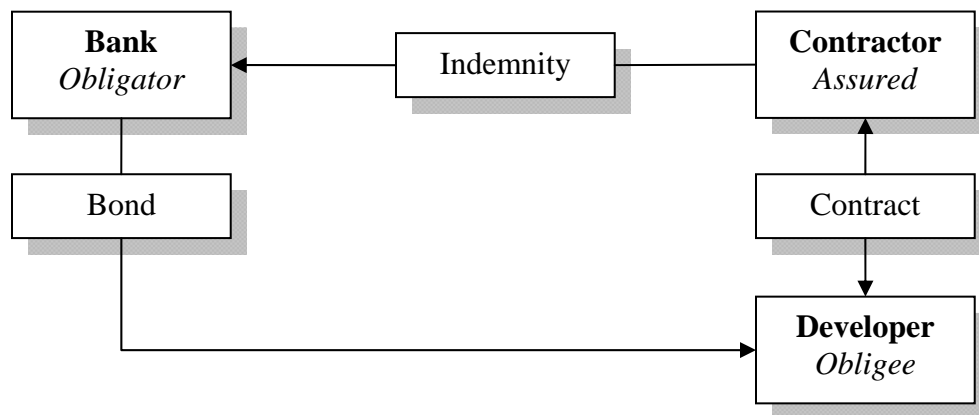


Figure 1.1: Relationships of Parties to a Bond and the Underlying Contract⁵

The validity period of the performance bond is as indicated in Figure 1.2 below. By clause 37(b), the performance bond is required to be maintained for such period as provided in the PWD Bond, i.e. until 6 months after the expiry of the Defects Liability

³ Khairuddin Abdul Rashid (2004), *Guarantee Against Non-Performance of Construction Contract by the Contractor: Performance Guarantee Sum versus Performance Bond*, Seminar, 1st International Conference, Toronto Canada, May 27 2004 – May 28 2004, World of Construction Project Management, p. 5

⁴ Lim Chong Fong (2004), *The Malaysian PWD Form of Construction Contract*, Sweet & Maxwell Asia, Petaling Jaya, p. 76

⁵ Chow Kok Fong (2004), *Law and Practice of Construction Contracts*, 3rd Edition, Sweet & Maxwell Asia, Singapore, p. 525

Period stated in the Contract calculated from the date of completion of the Works or any authorized extension thereto or if the contract is determined, until one year after the date of determination.⁶

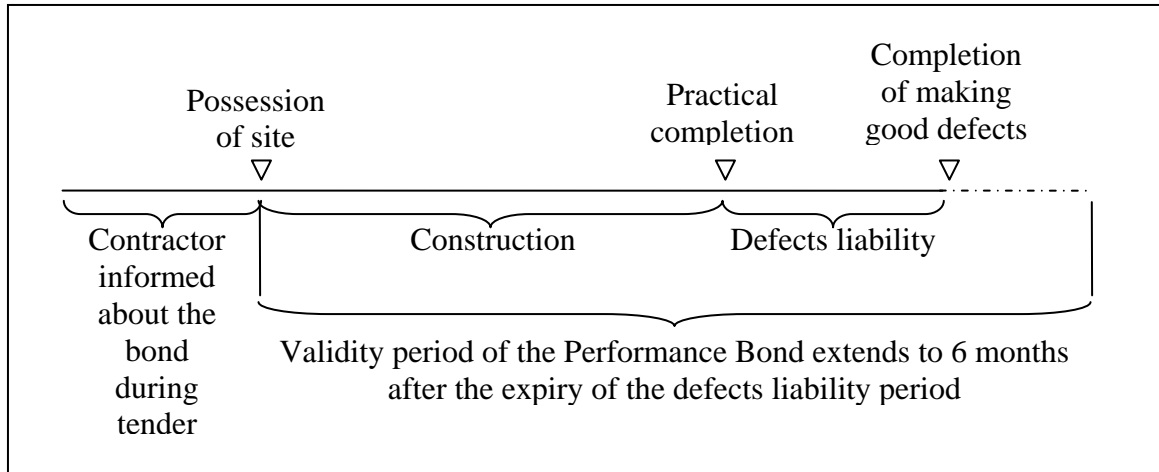


Figure 1.2: Time line indicating the validity period of the performance bond⁷

There are two types of performance bonds, as set out below.⁸

- *Conditional bond or default bond.* A default bond is a contract of guarantee whereby the surety accepts 'joint and several' responsibility for the performance of the contractor's obligations under the building contract: the contractor remains primarily liable for his performance and not protected by the bond.
- *Unconditional bond or on-demand bond.* An on-demand bond is a covenant by the surety (usually a bank) to indemnify the employer following contractor's default, subject to stated terms and up to a sum commonly between 10 and 20% of the main contract sum. The contractor is not a party to this arrangement.

⁶ Lim Chong Fong (2004), p. 77

⁷ Khairuddin Abdul Rashid (2004), p. 6

⁸ Nigel M. Robinson et. al. (1996), p. 205 but under on-demand bond in Malaysia, subject to stated terms and up to a sum commonly 5% of the main contract sum.

Thus, in order to determine the types of performance bond applicable in a contract, a thorough understanding of the content of the bond is required. The Court of Appeal in the famous *Teknik Cekap Sdn Bhd v Public Bank Berhad* [1995]⁹ held that:

Therefore a performance bond is nothing more than a written guarantee, and in order to interpret the obligations of the bank, one need only to look at the written bond itself to determine what are the terms and conditions agreed upon between the parties. A great deal, therefore, depends on the wording of the bond itself.

1.2 Problem Statement

As discussed above, there are two types of performance bond. The distinction between conditional and unconditional 'on demand' guarantee is also been discussed in the case of *China Airlines Ltd v Maltran Air Corp Sdn Bhd (formerly known as Maltran Air Services Corp Sdn Bhd) and Another Appeal* [1996]¹⁰ and later is agreed upon in the case of *Government of Malaysia v South East Asia Insurance Bhd* [2000]¹¹. In the former case, the court cited that:

A bank guarantee is a performance bond. There are two types of performance bond. The first type is a conditional bond whereby the guarantor becomes liable upon proof of a breach of the terms of the principal contract by the principal and the beneficiary sustaining loss as a result of such breach. The guarantor's liability will therefore arise as a result of the principal's default. The second type is an unconditional or 'on demand' performance bond which is so drafted that the guarantor will become liable merely when demand is made upon him by the beneficiary

⁹ [1995] 3 MLJ 449

¹⁰ [1996] 2 MLJ 517

¹¹ [2000] 3 MLJ 625

with no necessity for the beneficiary to prove any default by the principal in performance of the principal contract.

However, in Malaysia, for the past 20 years and since the famous *Teknik Cekap Sdn Bhd v Public Bank Berhad* [1995]¹² to the recent *Suharta Development Sdn Bhd v United Overseas Bank (M) Bhd & Anor* [2005]¹³, the question of whether the performance bond in a construction contract is a conditional or an unconditional guarantee is still one of the issues relating to performance bond that been discussed.

In *Suharta Development Sdn Bhd v United Overseas Bank (M) Bhd & Anor* [2005]¹⁴, Abdul Wahab Said Ahmad JC stated that:

A performance bond or guarantee is in fact a written contract to guarantee due performance in the event of breach or non performance of the contract. In determining whether it is conditional or otherwise, the court is concerned with the contractual construction or interpretation of the bond or guarantee itself. A great deal depends on the wording of the guarantee itself to discover the intention of the parties.

*The defendant contended that the terms of the guarantee is conditional and cited **Teknik Cekap Sdn Bhd v Public Bank Bhd** [1995] 3 MLJ 449 whilst the plaintiff relied on **LEC Contractors (M) Sdn Bhd (formerly known as Lotterworld Engineering & Construction Sdn Bhd) v Castle Inn Sdn Bhd & Anor** [2000] 3 MLJ 339. In both the cases the terms of the bond are similar to that in the case before me. The Court of Appeal in **Teknik Cekap Sdn Bhd** held the bond to be conditional but in **LEC Contractors (M) Sdn Bhd** held it is an on demand bond.*

¹² [1995] 3 MLJ 449

¹³ [2005] 2 MLJ 762

¹⁴ *ibid*

*In LEC Contractors (M) Sdn Bhd Mokhtar Sidin JCA distinguished the case of **Teknik Cekap** and at p 358 said:*

*That is the position of an on demand performance bond. It is clear to us that the bank guarantee in the present appeal is a performance bond. From the wordings of the guarantee it is clear to us that it is 'on demand' performance bond as stated in **Esso Petroleum Malaysia Inc v Kago Petroleum Sdn Bhd**: 'All that was required to trigger them was a demand in writing'; or in the words of Mohamed Dzaidin FCJ in the case of **China Airlines Ltd v Maltran AirCorp Sdn Bhd**: 'the guarantor will become liable merely when demand is made upon the beneficiary with no necessity for the beneficiary to prove any default by the principal in performance of the principal contract'.*

*The appellant claimed that the bank guarantee is a conditional bond. To support this contention learned counsel for the appellant referred to the case of **Teknik Cekap**, a decision of this court where the court held that a performance bond was a conditional bond. It was held by the court that because the bond began the words: 'If the subcontractor ... shall in any respect fail to execute the contract or commit any breach of his obligations thereunder then the guarantor shall pay'. Apparently this is the case in Malaysia where similar wordings has been used where the court has held that it was a conditional bond.*

From the above case, therefore, it is important to determine the content of the performance bond: whether the client can call upon the bond in the case of non-performance of the contractor or can the bank restraint the client from calling the bond among other. So, the phrase(s) in the bond shall be the issue of discussion.

This phrase(s) should also be in written form. A clear written phrase(s) that make up the content of the performance bond can clear the distinction between conditional and unconditional on demand guarantee.

Hence it is important and necessary to understand the circumstances in performance bond, which will be available to the parties to a building contract. And from that, the parties involved will clearly defined their rights and liability against bonds and guarantee to assist the respective party in construction contract.¹⁵

1.3 Objective of Topic

As such, this Masters Project has the objective to determine the phrase(s) in the Performance Bond in a construction contract that determine whether the performance bond is a conditional or an unconditional on demand guarantee. By clearing this issue, it is hoped that no more dispute will arise under the interpretation of the content of the Performance Bond especially in a construction contract.

1.4 Previous Research

There is quite a number of similar research have been done previously. The first was by Dr Khairuddin Abdul Rashid called *Guarantee against Non-performance of Construction Contract by the Contractor: Performance Guarantee Sum versus Performance Bond*. This research was presented at the 1st International Conference at Toronto, Canada on May 27 2004 to May 28 2004 organized by the World of

¹⁵ Nur'Ain Ismail (2007), *Performance Bond and An Injunction*, Master's Project Report (Dissertation), Universiti Teknologi Malaysia, p. 6.

Construction Project Management. This study aims to fulfill two key objectives: to review literature and Government documents relating to the rules on the requirement for performance bond or performance guarantee sum for public infrastructure contracts in Malaysia; and to assess the consequences to the Government of the contractors' opting for either the performance bond or the performance guarantee sum.

The second was by En. Jamaluddin Yaakob called *Performance Bond in Construction Contract: Problems with Drafting & Calling the Bonds*. This research was presented at the seminar on Issues on Non-Performance of Construction Contract at Rumah Alumni, Universiti Teknologi Malaysia, Skudai, Johor on February 26 2005 organized by the Department of Quantity Surveying, Faculty of Built Environment, Universiti Teknologi Malaysia. The main objective of this paper is examine the correlation between the wordings of performance bonds and the problems that arise when making a call on the bond.

The third was by Nur'Ain Ismail called *Performance Bond and An Injunction*. This research was a master's project report (dissertation) submitted on July 2007 in fulfillment of the requirements for the award of the degree of Master in Science of Construction Contract Management, Universiti Teknologi Malaysia. The objective of the study is to identify legal principles used by the courts in granting or rejecting an application for injunction against bondsmen from making payment or against employer from receiving the bonds.

1.5 Scope of Topic

As far as the scope of study is concerned, this Masters Project paper gather some medium of literatures such as the standard forms of contract (for example, PWD203A),

other related documents (for example, Bank Guarantee for Performance Bond or PWD Q7/81), and relevant law cases (for example, from Malayan law Journal) as well as Reference Books and other mediums (for example, journals, articles, magazines, newspapers, internets, etc.) for analyzing the legal interpretation between conditional and unconditional on demand performance bond in construction contract.

1.6 Significance of Topic

As has been mentioned in the objective, this research is important to the construction industry because it determines the phrase(s) in the Performance Bond in a construction contract whether the phrase(s) is/are conditional or unconditional on demand guarantees. By clearing this issue, it is hoped that no more dispute will arise due to the interpretation of the content of the Performance Bond especially in a construction contract. Hopefully, this study will add as a reference to the Malaysian construction contract practice to be more effective.

1.7 Methodology and Research Process

Basically, this Masters Project paper adopts five steps as its methodology and research process in order to achieve its objective. The steps are discussed further as follows:

Step 1: Identification of Research Topic

This is to give a thorough understanding what is this research is all about with some initial definition of the topic under study.

Step 2 **Research Objective**

This is the determining of what the research is hoping to achieve in studying the determination on the phrase(s) in the Performance Bond in a construction contract whether they is/are conditional or unconditional on demand guarantees.

Step 3: **Data Collection**

This is of course the gathering and consuming the medium of literatures as stated in the Scope of Study above. The medium of literatures is divided into two categories, namely the primary data and secondary data as shown in Figure 1.3 below.

Step 4: **Analysis**

This is the main text of this Masters Project dissertation which is analyzing and commenting the content of the Performance Bond in relation to whether it is a conditional or an unconditional on demand guarantee through the legal point of view from the examples of judgment held in law cases and later written systematically into chapters in this Masters Project paper. By using the words ‘Performance Bond’, 67 cases for the past 20 years were downloaded from the Malayan Law Journal to be analyzed further. From the first reading and screening of the above cases, the judge of 25 cases did interpret the distinction between ‘conditional’ and ‘unconditional’ Performance Bond. Further screening was done from the 25 cases whereby only cases which the judge discussed on the wordings or phrase(s) of the Performance Bond will be further analyzed. From this, 15 cases were identified to be further consumed.

Identification of Research Topic

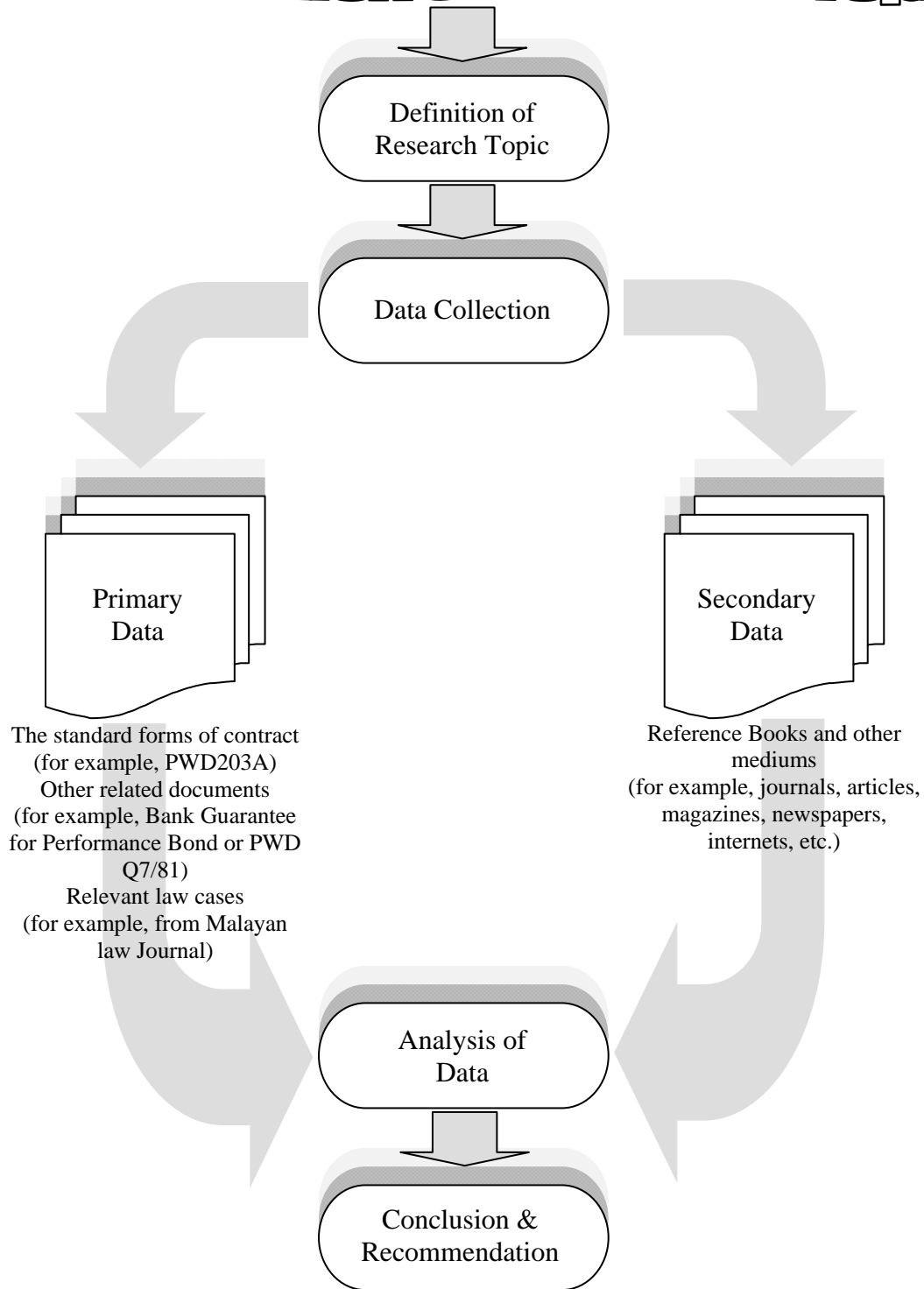


Figure 1.3: *Flowchart of the research methodology*

Step 5: **Conclusion and Recommendation**

This step concludes and summarizes the whole of the Masters Project paper, the outcome of objective achievable as well as making some recommendations to the outcomes. This Masters Project paper also hope to produce a new revised Bank Guarantee for Performance Bond that cleared the issue of interpreting the content whether it is conditional or not.

1.8 The organizational of the research proposal

This Masters Project paper seeks to achieve its aim in five chapters with the main reference will be the identification of phrase(s) in the Performance Bond in a construction contract that differentiate between conditional and unconditional on demand guarantee:

Chapter 1: **Introduction**

The introduction is the first chapter consists of the overview of this Masters Project paper as well as stating the aim and objectives, issue or problem statement, scope and methodology of study, previously similar research, and brief description of chapter organization.

Chapter 2: **Performance Bond**

The second chapter is basically the brief information on the bond application, management and its effectiveness in the Malaysian construction contract practice.

Chapter 3: **Comparative Analysis: Conditional versus Unconditional Performance Bond**

The third chapter is basically the detail legal issues regarding the identification of phrase(s) in the Performance Bond that differentiate between conditional and unconditional on demand guarantee.

Chapter 4: **Conclusion and Recommendation**

Lastly, chapter five conclude and summarize the whole of the paper, the outcome of objective achievable as well as making some recommendation to the outcomes as well as developing a new Bank Guarantee for Performance Bond. This will add to the existing references for students and practitioners in the Malaysian Construction Industry especially in the context of Construction Contract Management.