

THE RESTRAINTS OF PERFORMANCE BOND CLAIMS IN CONSTRUCTION  
INDUSTRY

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## ABSTRACT

Construction industry is full of uncertainties. It is a risky enterprise. Due to the recent problems of the construction industry, various bonds are required. Performance bond is used to guarantee performance of contract and protect the owner from financial loss due to the failure of the contractor to perform. It has held as a comprehensive and reliable instrument for minimizing the risks in construction projects. However there are some issues that may obstruct the real purpose of performance bond and restrained the performance bond claim. In *Teknik Cekap Sdn Bhd v Public Bank Bhd*, defective notice in calling performance bond had obstructed the real purpose of performance bond. Besides, in *Edward Owen Engineering Ltd v Barclays Bank International Ltd and another*, it stated that if there is clear fraud, the surety does not have to pay according to its guarantee. In *Min Thai Holdings Pte Ltd v Sunlabel Pte Ltd & Anor*, it also stated that unconscionability is another restraint of performance bond claims. These few case laws show that there are some circumstances that restrain performance bond claims. Therefore this research is conducted to identify the circumstances that restrain the performance bond claims in construction industry. This research is conducted by documentary analysis. In order to achieve the objective of this research, 16 Malaysia law cases which succeed in restraining the performance bond claim in construction industry are analyzed. These cases are Malayan Law Journal (MLJ) cases which are available in the database of *Lexis Malaysia* website. From the findings of this research, it can be concluded that the circumstances that restrain performance bond claims in construction industry are unconscionable conduct, prevention of irretrievable injustice, invalid demand, serious issues to be tried, balance of convenience, fraud, premature contract termination and no right to claim performance bond.

## ABSTRAK

Industri pembinaan penuh dengan ketidakpastian dan berisiko. Oleh sebab masalah dalam industri pembinaan, beberapa bon diperlukan. Bon pelaksanaan digunakan untuk menjamin pelaksanaan kontrak dan melindungi pemilik daripada kerugian kewangan yang disebabkan oleh kontraktor yang gagal melaksanakan kerja. Bon pelaksanaan dianggap sebagai instrumen yang komprehensif dan boleh dipercayai bagi mengurangkan risiko dalam projek pembinaan. Manakala terdapat beberapa isu-isu yang menghalang tujuan sebenar bon ini dan menyebabkan tuntutan bon pelaksanaan terhalang. Dalam *Teknik Cekap Sdn Bhd v Public Bank Bhd*, notis yang tidak sempurna telah menghalang tujuan utama bon pelaksanaan. Selain itu, dalam kes *Edward Owen Engineering Ltd v Barclays Bank International Ltd and another*, ia menyatakan bahawa jika terdapat ‘*clear fraud*’, penjamin tidak perlu membayar berdasarkan jaminannya. Dalam *Min Thai Holdings Pte Ltd v Sunlabel Pte Ltd & Anor*, ia juga menyatakan bahawa ‘*unconscionability*’ ialah penghalang bagi tuntutan bon pelaksanaan. Beberapa kes ini menunjukkan bahawa terdapat beberapa keadaan yang menghalang tuntutan bon pelaksanaan. Oleh itu, kajian ini dijalankan untuk mengenal pasti keadaan yang menghalang tuntutan bon pelaksanaan dalam industri pembinaan. Kajian ini dijalankan melalui analisis dookumen. Untuk mencapai objektif kajian ini, 16 kes dalam Malaysia yang telah berjaya menghalang tuntutan bon pelaksanaan dalam industri pembinaan telah dianalisis. Kes-kes ini ialah kes dalam Malayan Law Journal (MLJ) yang terdapat dalam pangkalan data di laman web *Lexis Malaysia*. Melalui kajian ini, boleh disimpulkan bahawa keadaan yang menghalang tuntutan bon pelaksanaan dalam industri pembinaan ialah tindakan yang ‘*unconscionable*’, pencegahan ketidakadilan yang tidak dapat ditebus, tuntutan yang tidak sah, isu serius yang perlu dipertikaikan, imbalan kesesuaian, ‘*fraud*’, penamatan kontrak yang terlalu awal, dan tiada hak untuk menuntut bon pelaksanaan.

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**LIST OF ABBREVIATIONS**

|             |   |
|-------------|---|
| All ER      | All England Law Reports                 |
| BLR         | Building Law Reports                    |
| CA          | Court of Appeal                         |
| CIDB        | Construction Industry Development Board |
| CLJ         | Current Law Journal (Malaysia)          |
| DB          | Design and Build                        |
| HL          | House of Lords                          |
| Lloyd's Rep | Lloyd's List Reports                    |
| MLJ         | Malayan Law Journal                     |
| MLJU        | Malayan Law Journal Unreported          |
| PAM         | Pertubuhan Arkitek Malaysia             |
| PWD         | Public Work Department                  |
| QB          | Queen Bench                             |
| SC          | Supreme Court                           |
| SGHC        | Singapore High Court                    |
| SLR         | Singapore Law Report                    |
| WLR         | Weekly Law Report                       |

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| <i>TKM Property Sdn Bhd v Syarikat KMZ Sdn<br/>Bhd &amp; Anor [2007] 2 MLJ 594</i>   | 63,67,73,83,86,93,95             |
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## CHAPTER 1

### INTRODUCTION

#### 1.1 Background of Research

Construction is a business which is full of uncertainties.<sup>1</sup> For examples, economic crisis, labour issues (shortage, quality, legislations), insufficient building materials, lack of equipments. Some instances may cause the building construction business to fail and projects are left at a standstill or abandon.<sup>2</sup>

Construction is considered a risky enterprise.<sup>3</sup> This is due to the high failure rate in construction industry compared to other industries.<sup>4</sup> Even capable contractors may fail. According to BizMinerin United State, in year 2006, there are 1,155,245 contractors in business, but after two years, only 919,848 left. This contributes a 20.37% failure rate.<sup>5</sup> Similarly, Construction Industry Development Board, Malaysia (CIDB) stated that 11,321 construction companies in Malaysia were inactive from

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<sup>1</sup> Abdul Aziz Hussin, Unperformed Performance Bond in Construction Industry, Malayan Law Journal Articles 1 (2011)

<sup>2</sup> *Ibid.* footnote 1

<sup>3</sup> Surety Information Office (SIO), The importance of Surety Bonds in Construction, Retrieved on March 6, 2012 from <[www.sio.org/pdf/importanceof.pdf](http://www.sio.org/pdf/importanceof.pdf)>(2009)

<sup>4</sup> Koon Yew Yin, "How to become a competent contractor". The Monthly Bulletin of the institution of Engineers, Journal of Jurutera, Malaysia 2, (2006): 38-39

<sup>5</sup> *Supra*, footnote 3.

January 2006 to August 2008.<sup>6</sup>

Due to the recent ills of the construction industry, it resulted in bonds being required in both public and private projects. A surety bond is required or demanded.<sup>7</sup> Wikipedia defines surety bond as a guarantee given by the surety to reimburse the obligee a certain sum of money due to the non-compliance of certain contractual obligations by the principal.<sup>8</sup>

The surety bond protects the obligee from suffering losses due to the principal's failure to meet the obligation.<sup>9</sup> Surety bonds shifted the risks of project completion from the owner to the surety company.<sup>10</sup> Therefore, many private owners oblige their contractors to provide surety bond in order to protect their company and shareholders from the large amount cost due to the contractor's failure.

Basically there are three types of contract surety bonds.<sup>11</sup> Firstly is the bid bond. It guarantees that the bid has been submitted sincerely and that the contract will be entered by the contractor at the price bid and provides the required performance and payment bonds. Secondly is performance bond, which protects the owner from financial loss due to the contractor who fails to perform the contract according to its terms and conditions. Lastly is the payment bond. It guarantees the payment of the contractor to the subcontractor, labours or suppliers.

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<sup>6</sup> M.S. Ab. Halim, M. Jaafar, and O.Osman, Financial Management Practices: An Assessment Of Malaysian Construction Company, *Journal Design + Build* 3 (2010): 22-40

<sup>7</sup> Cheryl S. Kniffen, A Georgia Practitioner's Guide to Construction Performance Bond Claims, *Mercer Law Review* 60:2 (2009): 509-532

<sup>8</sup> Wikipedia, Surety Bond, Retrieved on March 7, 2012 from <[http://en.wikipedia.org/wiki/Surety\\_bond](http://en.wikipedia.org/wiki/Surety_bond)> (January 17, 2012)

<sup>9</sup> Supra, footnote 8.

<sup>10</sup> Supra, footnote 3.

<sup>11</sup> *Ibid.* footnote 3.

Performance bond is a key component of contract bonding within the construction industry.<sup>12</sup> A performance bond is defined as a written guarantee provided by a third party, which usually is a bank or an insurance company. It guarantees a payment of specified sum to the beneficiary of the bond (e.g. an employer) if the party providing the bond (e.g. a contractor) fails to perform its contractual obligations.<sup>13</sup> Usually contractors need to provide a performance bond upon being awarded a contract.<sup>14</sup>

Generally there are two types of performance bond<sup>15</sup>. There two types of performance bond are conditional bond and unconditional or demand bond. Usually conditional bond is found in construction industry. Conditional bond means that the surety only agrees to reimburse the obligee if the specified conditions are satisfied such as breach of contract.<sup>16</sup> The second type is unconditional or demand bond. The beneficiary can call upon the surety for payment without considering any default under the principal contract and provided that there is no fraud.<sup>17</sup>

Through years, performance bond has held as a comprehensive and reliable instrument for minimizing the risks in construction projects, both in public and private.<sup>18</sup> The ideal concept is to ensure that the contractor's (including subcontractor's) or supplier's honours their promise at the agreed price, and within the time specified.<sup>19</sup> They need to perform the contract according to its terms and conditions.<sup>20</sup> Upon the contractor's failure to perform completely, the employer can

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<sup>12</sup> Performance Bonds, Retrieved on March 6, 2012 from <<http://www.suretybonds.com/performance-bonds.html>>

<sup>13</sup> [Hawkswell Kilvington](http://www.thkp.co.uk/2012/02/03/how-secure-is-your-security/), How Secure Is Your Security? Retrieved on March 5, 2012 from <<http://www.thkp.co.uk/2012/02/03/how-secure-is-your-security/>> (February 3, 2012)

<sup>14</sup> Supra, footnote 12

<sup>15</sup> John Murdoch and Will Hughes, *Construction Contracts: Law and Management*, Fourth Edition, (Great Britain: Taylor & Francis, 2008), 245

<sup>16</sup> *Ibid.* footnote 15

<sup>17</sup> [1978] QB 159 (CA) at p 171

<sup>18</sup> Supra, footnote 1.

<sup>19</sup> *Ibid.* footnote 1

<sup>20</sup> *Ibid.* footnote 1

call on the performance bond to reimburse the loss, up to the maximum amount of the bond.<sup>21</sup> The performance bond prevents financial loss for the project owner.<sup>22</sup>

The role of performance bond as security to pay for construction defects is becoming more important.<sup>23</sup> In United Kingdom, there are now 25 states that do not cover construction defects under commercial general liability policies insuring contractors.<sup>24</sup> The number of policy exclusions and limitations are increasing so in many situations the contractor's insurance policy is inadequate (or non-existent) protection against defects. Although performance bonds are greatly used in the industry, many contractors fail to understand their exact purpose.<sup>25</sup>

## 1.2 Statement of Problem

Performance bond is used to guarantee performance of the contract.<sup>26</sup> It provides financial security and construction assurance by guaranteeing the project owners that the project will be completed by the contractors in accordance to the terms of the contract. It reduces the risks in construction industry. However there are some issues that may obstruct the real purpose of performance bond and caused restraint in performance bond claiming.<sup>27</sup>

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<sup>21</sup>Soh Lip San, Performance Bond, Retrieved on March 4, 2012 from <<http://www.lawgazette.com.sg/2002-10/Oct02-feature2.htm>> (October, 2002)

<sup>22</sup>Supra, footnote 12

<sup>23</sup>*Ibid.* footnote 12

<sup>24</sup>Eric Grasberger, The Increasing Importance of Performance Bonds, Retrieved on February 23, 2012 from <<http://www.aheadofschedulelaw.com/2011/05/articles/alternative-dispute-resolution/the-increasing-importance-of-performance-bonds/>> (May 20, 2011)

<sup>25</sup>Supra, footnote 12

<sup>26</sup>Supra, footnote 1

<sup>27</sup>*Ibid.* footnote 1

Firstly is due to defective notice in calling conditional performance bond.<sup>28</sup> In *Teknik Cekap Sdn Bhd v Public Bank Bhd*<sup>29</sup>, where the wording of the guarantee states:

*“If the subcontractor (unless relieved from the performance by any clause of the contract or by statute or by the decision of a tribunal of competent jurisdiction) shall in any respect fail to execute the contract or commit any breach of this obligations thereunder then the guarantor shall pay to the contractor up to and not exceeding the sum of ...”*

In that case, the main contractor calls for payment of performance bond from the bank without specifying the breach or stating that the subcontractor had failed to perform. The bank paid up. The subcontractor then sued the bank and the bank in third party proceedings claimed the money back from the main contractor. The Court of Appeal held that the demand was bad because the guarantee required the main contractor to assert that a breach had occurred. Therefore the performance bond is repaid by the main contractor to the bank.

Moreover, fraud will restrain the payment of performance bond too. In *Edward Owen Engineering Ltd v Barclays Bank International Ltd and another*<sup>30</sup>, the court states that:

*“... A bank which gives a performance guarantee must honour that guarantee according to its terms. ... The bank must pay according to its guarantee, on demand, if so stipulated, without proof or conditions. The only exception is when there is clear fraud of which the bank has notice.”*

This means that if there is a clear fraud, then the bank does not have to pay according to its guarantee. This is also stated in the case of *IE Contractors Ltd v Lloyds Bank Plc and Rafidain Bank*<sup>31</sup>. Legatt J held (at p 207):

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<sup>28</sup>*Ibid.* footnote 1

<sup>29</sup>[1995] 3 MLJ 449 (CA).

<sup>30</sup>[1978] QB 159 (CA) at p 171

*“Except, therefore, where there is clear and obvious fraud, the issuing bank must honour its first demand bond according to its terms ...”*

Unconscionability is another restraint of performance bond claims. The concept of unconscionability is defined by *Min Thai Holdings Pte Ltd v Sunlabel Pte Ltd & Anor*<sup>32</sup>. The High Court defined the concept of unconscionability as:

*‘involves unfairness, as distinct from dishonesty or fraud, or conduct so reprehensible or lacking in good faith that a court of conscience would either restrain the party or refuse to assist the party’.*

The Court of Appeal Singapore in *Bocotra Construction Pte Ltd & Ors v Attorney General (No 2)*<sup>33</sup> states:

*“In our opinion, whether there is fraud or unconscionability is the sole consideration in applications for injunctions restraining payment or calls on bonds to be granted.”*

This means that if there is fraud or unconscionability, the injunctions to restrain payment or calls on bonds will be granted. In this case, the performance bond cannot be claimed.

In *Newtech Engineering Construction Pte Ltd v. BKB Engineering Constructions Pte Ltd & Others*<sup>34</sup>, the applications was on the basis that the call of the bonds was made in bad faith and unconscionably as the first defendants had no honest belief that the plaintiffs had failed to perform their contractual obligations. Since the first defendants’ financial condition has some problems, so the calls were believed to be made with the intention of using the money payable under the bonds to pay their creditors. In this case, the bank can either avoid payment.

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<sup>31</sup>[1989] 2 Lloyd’s Rep 205.

<sup>32</sup>[1999] 2 SLR 368 (HC).

<sup>33</sup>[1995] 2 SLR 733 (CA) at p 746.

<sup>34</sup>[2003] SGHC 141; [2003] 4 SLR 73

In some situations, letter or notice of demand in writing shall be made. In ***Teknik Cepak Sdn Bhd v Public Bank Bhd***<sup>35</sup>, Shaik Daud JCA added:

*“There is no doubt that some performance bond must be paid merely on a demand being made, and whether this is so must depend on the wordings of the bond itself.”*

In ***Merit Properties Sdn Bhd v Aktif Lifestyle Stores Sdn Bhd (formerly known as Yaohan Sdn Bhd & Anor)***<sup>36</sup>, Richard Malanjum JCA states:

*“It is a matter of construction. If the said guarantees are ruled to be unconditional, it would give the appellant the right to call upon the said guarantees and the second respondent would have to make payments on the first and second guarantees pursuant to the demand made by the appellant. ... The first guarantee was 'on demand' ... All that is required to trigger payment is a demand in writing. ... In fact, the present performance bond, had it been worded, eg to require any proof of breach by the buyer so as to deserve any payment, then, in such event, its commercial acceptability as a performance bond, would be mostly lost.”*

In ***Esso Petroleum Malaysia Inc v Kago Petroleum Sdn Bhd***<sup>37</sup>, the Supreme Court ruled that the performance bond was a pure 'on demand' guarantee on a true construction. In order to trigger the bond, all that was required was a demand in writing.

Another important matter to be taken into consideration by the claimant is that the requirement that the notice of demand must be served<sup>38</sup>. In ***Malayan Assurance Alliance Bhd v Then Fah Chin***<sup>39</sup>, the notice must be served is the issue

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<sup>35</sup> [1995] 3 MLJ 449 (CA).

<sup>36</sup> [2007] 5 MLJ 28; [2007] 4 CLJ 128 (CA)

<sup>37</sup> [1995] 1 MLJ 149; [1995] 1 CLJ 283 (SC)

<sup>38</sup> *Supra*, footnote 1

<sup>39</sup> [1997] MLJU 381; [1997] 1 LNS 464 (HC)



that have arisen. However the court found that the plaintiff had sufficiently proved that the letter of demand is addressed to the defendant and the proof of posting. Although the plaintiff has no default in serving notice, the court had emphasized that the notice of demand must be served.

From the above-mentioned problems, it can be seen that there are some circumstances that restrain the claim of performance bond and stop the performance bond to perform as security to prevent financial loss for the project owner. These circumstances obstruct the real purpose of performance bond. Therefore it is necessary to conduct a research to identify the circumstances that restrain the performance bond claims.

### **1.3 Objective of the Research**

The objective of this research is to identify the circumstances that restrain the performance bond claims in construction industry.

### **1.4 Research Question**

Below is the research question of this research:

1. What are the circumstances that restrain the performance bond claims in construction industry?

## 1.5 Scope of the Research

The approach adopted in this research is based on case law. This research will only discuss the cases regarding the issue of circumstances that restrain performance bond claims in Construction industry. In this case, only Malaysia law cases which succeed in restraining the performance bond claim will be discussed and analyzed. The relevant court cases are limited to those related to construction or building contract. The sources of the cases are relevant cases from Malayan Law Journal (MLJ) which are available in the database of *Lexis Malaysia* website.

## 1.6 Significance of the Research

In the main contract, performance bond intended to provide assurance to the project owners that the project will be completed by main contractor; in subcontract, it provides assurance to the main contractor due to subcontractor's work.<sup>40</sup> It is undeniable that performance bond plays an important role in construction. However there are some circumstances that make the performance bond unperformed as security to prevent financial loss for the project owner.<sup>41</sup> Therefore it is necessary to find out what are the circumstances that obstruct its real purpose.

The purpose of this research is to identify the circumstances that restrain the performance bond claims. It is strongly believed that this research can increase the awareness of relevant parties such as project owners, contractors or subcontractors due to the unperformed performance bond in construction industry. The findings of this research will also help the relevant parties to understand their rights, duties and

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<sup>40</sup>Supra , footnote 1

<sup>41</sup>Supra, footnote 12

liabilities in calling on performance bond or receiving the payment. As a result potential disputes can be reduced.

In addition, the findings can be as a guideline or advice to the general practitioner either in navigating a performance bond claim or raising defenses to a performance bond claim.<sup>42</sup>The claimant will avoid the happening of those circumstances so that they can successfully claim the performance bond. However for the defendant, they would know at which circumstances, the claimants are unable to claim performance bond such as wrongful call of performance bond claim, fraud and etc. The findings help them to protect their rights in defending their performance bond. This will improve the effectiveness of performance bond in construction contract practice.

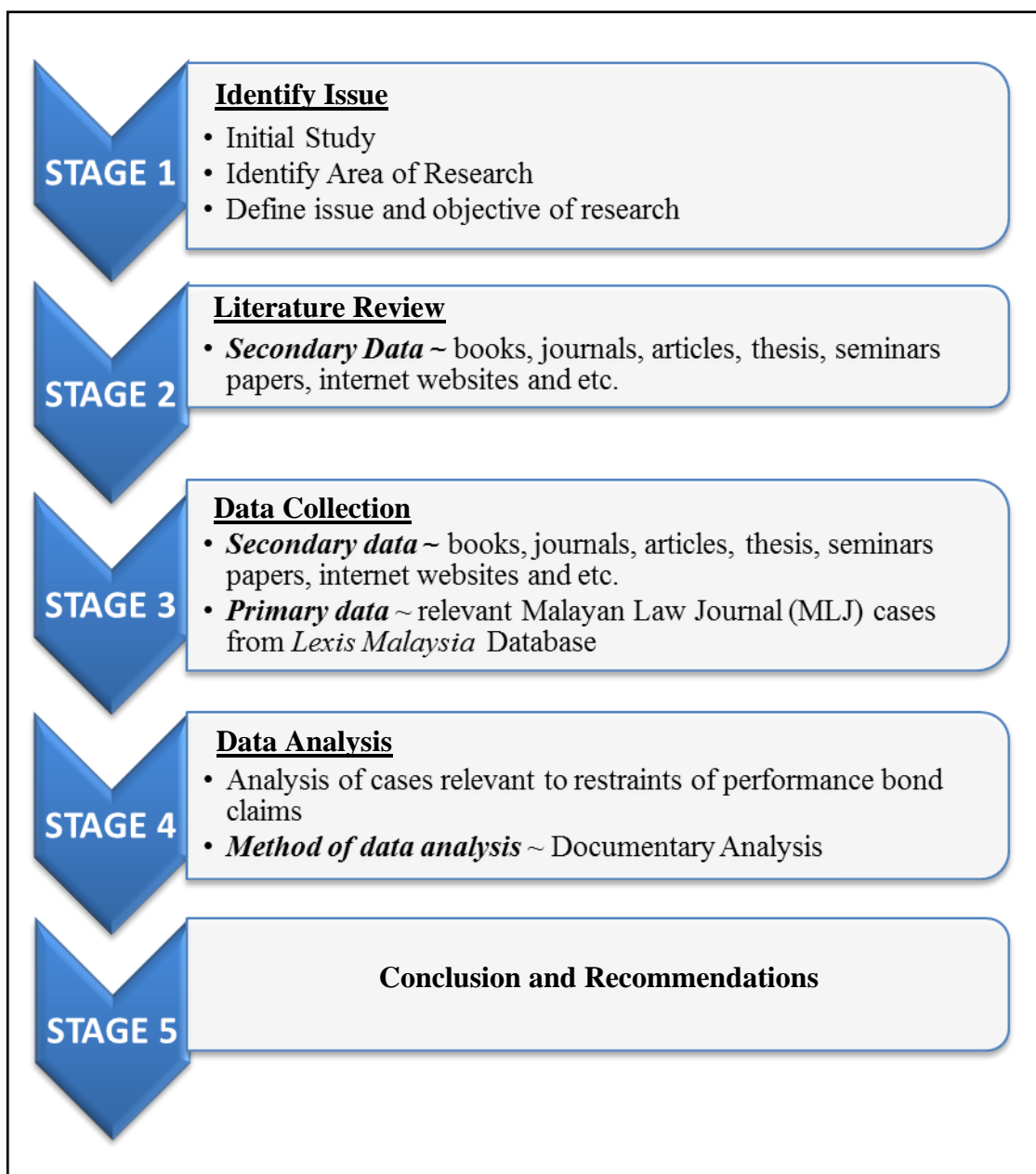
## **1.7 Research Methodology**

The methodology of this research is by documentary analysis. In order to achieve the objective of this study, a systematic process of conducting this research had been planned. Basically, the process of this research consists of five main stages. There are:

- a. Identify the issue of the research
- b. Literature review
- c. Data collection
- d. Data analysis
- e. Conclusion and suggestions

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<sup>42</sup>Supra, footnote 7



**Figure 1.1 : Research Methodology**

## **1.8 Organisation of Chapters**

Organisation of chapters is a summary of the content for the Research Project Report. The report consists of four chapters:

**a) *Chapter 1 : Introduction***

This chapter covers the background of the research, statement of problem, research objective, research question, scope of research and significance of research. This chapter also explains the research methodology of this research.

**b) *Chapter 2 : Performance Bond***

This chapter is the literature review for the research. It explains the data and information gain from secondary resources. It consists of the definition of performance bond, the purpose of performance bond, nature of performance bond and the types of performance bond. This chapter also studies on the role of performance bond in construction contract. The performance bond claim and the restraints in performance bond claims are also discussed in this chapter.

**c) *Chapter 3 : Analysis of Law Cases***

This chapter presents the findings achieved from documentary analysis of the law cases. The law cases are analyzed and discussed.

**d) *Chapter 4 : Conclusion and Recommendations***

This chapter concludes the findings of the research and a few recommendations are suggested.

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