

UNCONSCIONABLE CALL OF PERFORMANCE BOND

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A master's project report submitted in partial fulfillment of the
requirements for the award of the degree of
Master of Science in Construction Contract Management.

Faculty of Built Environment
Universiti Teknologi Malaysia

SEPTEMBER 2013

Το μψ βελοπεδ Υμι, μψ βροττηερσ ανδ μψ σιστερσ
φορ τηειρ ενδλεσσ λοπε, χαρε ανδ συππορτ
Τηανκ ψου σο μυχη□
Μαψ Αλλαη βλεσσ υσ□Αμεεν

Το μψ λατε Αβαη□
Ψουρ λοπε ωιλλ αλωαψσ βε ιν μψ ηεαρτ□.
Αλ-Φατιηαη□Αμεεν

ACKNOWLEDGEMENT

First and foremost, with high gratitude to Allah S.W.T. who gave me the chances, ideas and physical strength in preparing this master project. I wish to express my thankful to the persons and all parties who involved in this study and offered a valuables cooperation in carrying out this final project.

I am heartily thankful to my supervisor, Mr.Jamaludin bin Yaakob, for the encouragement, supervision and support from the preliminary to the concluding level enabled me to develop an understanding of the subject.

Furthermore, I would like to express my deepest appreciation especially to my beloved Umi, my late Abah and my entire family members who always supporting me and motivating me in a process to complete this master project.

Lastly, I offer my regards and blessings to all of those who supported me in any respect during the completion of the project.

Thank you so much.

ABSTRACT

Performance bond is one of the important provisions in construction contracts. The provision requires the contractor to give the employer security for the due performance of the contract. There are two types of performance bond. The first type is called conditional bond. It is a contract guarantee whereby the surety becomes liable upon proof of breach of the terms of the main contract by principal and the beneficiary sustaining loss as a result of such a breach. The second type is unconditional or 'on-demand' performance bond. It is a covenant whereby the surety becomes liable merely when a demand is made upon him by the beneficiary with no necessity for the beneficiary to prove any default by the principal in performance of the main contract. The main distinction between the two types of bond is with respect to the requirement for making call on the bond. In conditional performance bond, the beneficiary must comply with conditions precedent for calling the bond. In unconditional bond, the only condition precedent is a written notice to the surety. However, the contractor may apply for injunction against the employer to restrain the employer from calling the bond or receiving any payment under the performance bond. When considering the application for injunction, the courts have to determine the presence of fraud or unconscionable conduct by the employer. In most court cases, unconscionability had been interpreted as unfairness. In determining unconscionability, the court will use the test of 'balance of convenience' and 'seriously arguable and realistic inference test'. However, whether there is unconscionability depends on the facts of each case. There is no predetermined categorization. The court has to assess the whole facts of the cases to determine unconscionability. From the court cases, it can be concluded that there are two circumstances that amount to unconscionable conduct. Firstly, breach of contract by the contractor that is induced by employer's own default such as late payment and secondly, *force majeure* such as typhoon and flood.

ABSTRAK

Bon pelaksanaan merupakan salah satu peruntukan penting dalam kontrak pembinaan. Peruntukan bon pelaksanaan memerlukan pihak kontraktor untuk memberi jaminan kepada pemilik projek terhadap pelaksanaan kontrak. Terdapat dua jenis bon pelaksanaan. Pertama adalah bon pelaksanaan bersyarat iaitu perjanjian jaminan dimana penjamin bertanggungjawab terhadap kemungkiran kontrak pihak kontraktor dan pihak penama mengalami kerugian daripada kemungkiran tersebut. Jenis bon pelaksanaan yang kedua adalah bon tidak bersyarat. Bon ini merupakan perjanjian dimana penjamin bertanggungjawab apabila penama membuat tuntutan terhadap bon pelaksanaan tanpa memerlukan pihak penama untuk membuktikan kemungkiran oleh pihak kontraktor dalam kontrak utama. Bagi bon bersyarat, pihak penama (majikan) perlu memenuhi syarat-syarat untuk menuntut bayaran bon tersebut manakala untuk bon tidak bersyarat, penama hanya perlu memberi notis bertulis kepada penjamin untuk menuntut bayaran bagi bon tersebut. Namun begitu, pihak kontraktor boleh memohon injunksi dari pihak mahkamah untuk menghalang pihak majikan dari membuat tuntutan terhadap bon tersebut atau menghalang pihak majikan dari menerima bayaran dibawah bon tersebut. Dalam meluluskan permohonan pemberian injunksi, pihak mahkamah perlu menentukan kewujudan unsur ‘penipuan’ atau ‘ketidakpatutan’ dalam tuntutan pihak majikan terhadap bon pelaksanaan. Dalam kebanyakan kes mahkamah, ‘ketidakpatutan’ telah ditafsirkan sebagai ‘ketidakadilan’. Dalam menentukan kewujudan ‘ketidakpatutan’ ini, pihak mahkamah akan menggunakan ujian ‘imbangan kemudahan’ dan ujian ‘kesimpulan serious dan realistik’. Walaubagaimanapun, untuk menentukan ‘ketidakpatutan’ adalah bergantung kepada fakta setiap kes. Tiada kategori yang telah ditetapkan sebagai ‘ketidakpatutan’. Mahkamah perlu menilai setiap fakta kes secara menyeluruh. Merujuk kepada kes-kes mahkamah, dapat disimpulkan bahawa terdapat dua keadaan yang boleh membawa kepada ‘ketidakpatutan’ ketika membuat tuntutan terhadap bon pelaksanaan. Pertama, kemungkiran pihak kontraktor yang disebabkan oleh tindakan pihak majikan itu sendiri seperti kelewatan dalam bayaran kemajuan. Kedua, berlaku perkara diluar kawalan pihak kontraktor (*force majeure*) seperti ribut taufan dan banjir.

TABLE OF CONTENTS

	Content	Page
	TITLE	Ii
	DECLARATION	iii
	DEDICATION	vi
	ACKNOWLEDGEMENT	Vii
	ABSTRACT	Viii
	ABSTRAK	Ix
	TABLE OF CONTENTS	x-xi
	LIST OF CASES	xii-xiv
	LIST OF FIGURES	xv
	LIST OF ABBREVIATION	xvi
CHAPTER	TITLE	PAGE
1	INTRODUCTION	
	1.1 Background of Study	1
	1.2 Problem Statement	5
	1.3 Objective of Study	9
	1.4 Scope of Study	9
	1.5 Significance of Study	10
	1.6 Research Methodology	10
	1.7 Organization of Study	14
2	PERFORMANCE BOND & INJUNCTION	
	2.1 Introduction	16
	2.2 Types of Performance Bond	17
	2.2.1 Conditional Bond	19
	2.2.2 Unconditional Bond	20
	2.3 Nature of Bond	21
	2.4 Calling on the Performance Bond	23
	2.5 Injunction	24
	2.5.1 Type of injunction	24
	2.5.2 Statutory provision	25
	2.5.3 Application for injunction	
	2.6 Application for injunction to restrain calling on the performance bond and receiving the payment from performance bond	27
	2.6.1 Injunction against employer	27
	2.6.2 Injunction against banker / insurance company	29
	2.6.3 Conclusion	30

3	DOCTRINE OF UNCONSCIONABILITY	
3.1	Introduction	31
3.2	Development of Doctrine of Unconscionability	33
3.3	Nature of Unconscionability	35
	3.3.1 Freedom of Contract	37
	3.3.2 Will Theory	38
	3.3.3 Reasonable Expectation	38
3.4	Doctrine of Unconscionability and Injunction Relief	40
3.5	Balance of Convenience	45
	3.5.1 Application of Balance of Convenience	47
3.6	Effect of Application of Doctrine of Unconscionability In Granting Injunction	50
	3.6.1 Advantages	50
	3.6.2 Disadvantages	51
4	UNCONSCIONABILITY AS A GROUND FOR INJUNCTION APPLICATION	
4.1	Introduction	53
4.2	Principle in Bocotra Construction Pte Ltd & Others v Attorney General (No.2)	54
4.3	Circumstances of unconscionability in granting an application of injunction related to performance bond	57
	4.3.1 Breach of contract induced by beneficiary's own default	58
	4.3.2 <i>Force Majeure</i>	76
4.4	4.4 Summary of findings	80
5	CONCLUSION AND RECOMMENDATION	
5.1	Introduction	84
5.2	Summary of findings	85
5.3	Conclusion	87
5.4	Recommendation	88
5.5	Limitation of study	88
	REFERENCES	89
	BIBLIOGRAPHY	92

LIST OF CASES	PAGES
<i>Alor Janggus Soon Seng Trading Sdn.Bhd & Ors v Sey Hoe Sdn.Bhd & Ors</i> [1995] 1 MLJ 241	47
<i>American Cyanamad Co. v Ethicon Ltd</i> [1975] 2 WLR 316	45
<i>Astrata (Singapore) Pte Ltd v Tridex Technologies Pte Ltd</i> [2011] 1 SLR 449	32
<i>Balfour Beatty Civil Engineering v Technical & General Guarantee Co. Ltd</i> (2000) 68 Con LR 180	18
<i>Bocotra Construction Pte Ltd and Others v Attorney General (No.2)</i> [1995] 3 LRC 423	3, 6, 39, 40, 46, 53, 54, 56, 63, 80
<i>Boustany v Pigott</i> [1993] EGCS 85; [1993] 42 W.I.R 175	33
<i>BS Mount Sophia Pte Lyd v Join Aim Pte Ltd</i> [2012] SGHC 28	60, 86
<i>Burleigh Forest Estate Management Pty.Ltd v Cigna Insurance Australia Ltd</i> [1992] 2 QD R 54	43
<i>Chase Perdana Bhd v Md Afendi bin Hamdan</i> [2006] 5 MLJ 798	45
<i>China Airlines Ltd v Maltran Air Copr sdn.Bhd</i> [1996] 2 MLJ 517	18
<i>Dauphin Offshore Engineering & Trading Pte Ltd v The Private Office of HRH Sultan Shaikh Sultan bin Khalifa bin Zayed Al-Nahyan</i> [2000] 1 SLR 657	34, 72
<i>Edward Owen Engineering Ltd v Barclays Bank International Ltd</i> [1978] QR 159	2, 39
<i>Esal (Commodities) Ltd v. Oriental Cerdit Ltd</i> [1985] Lloyd's Rep 546	19, 54
<i>Esso Petroleum Malaysia Inc. v Kago Petroleum Sdn.Bhd</i> [1995] 1 MLJ 149	4, 5, 19, 21, 63
<i>Fasda Heights Sdn.Bhd v Soon Ee Sing Construction Sdn.Bhd & Anor</i> [1999] 4 CLJ 189	20
<i>Fry v Lane</i> (1888) 40 Ch. Div. 312	36

LIST OF CASES	PAGES
<i>Gammon Pte.Ltd v JBE Properties Pte Ltd (SCDA Architects Pte.Ltd, 3rd Party)</i> [2010] SGHC 130	71, 72, 73, 74
<i>GHL Pte.Ltd v Unitrack Building Construction Pte Ltd & Another</i> [1999] 4 SLR 604 (CA)	5, 39, 64, 65, 67, 68,71, 81
<i>IE Contractors v Lloyd Bank & Rafiadin Bank</i> [1990] 2 Lloyd's Rep 46	19
<i>JBE Properties Pte Ltd (SCDA Architects Pte Ltd 3rd Party)</i> [2010] SGHC 130	74, 85
<i>Join-Aim Pte Ltd v BS Mount Sophia Pte Ltd & Anor</i> [2012] SGHC 3	57, 58, 59, 60
<i>Kejuruteraan Bintai Kindenko Sdn.Bhd v Nam Fatt Construction Sdn.Bhd & Anor</i> [2011] 7 CLJ 444	8, 29, 47, 56
<i>Kvaerner Singapore Pte.Ltd v UDL Shipbuilding (Singapore) Pte Ltd</i> [1993] 3 SLR 350	80
<i>Labroy Offshore Ltd. v Master Marine AS & Others</i> [2011] SGHC 234	28
<i>LEC Contractor (M) Sdn.Bhd v Castle Inn Sdn.Bhd</i> [2000] 3 MLJ 339	41
<i>Malaysian Refining Co. Sdn.Bhd v Sumatec Enginerring & Construction</i> [2011] 7 CLJ 21	7, 69, 70
<i>Min Thai Holdings Pte Ltd v Sunlabel Pte Ltd & ANor</i> [1999] 2 SLR 368; [1999] SGHC 395	77, 78, 79, 80, 87
<i>Morrison v Coast Finance</i> [1965] 55 DLR (2d)	31
<i>Multi Service Book-binding Ltd v Marden</i> [1979] Dh 84	33
<i>Nafas Abadi Holiding Sdn.Bhd v Putrajaya Holding Sdn.Bhd & Another</i> [2004] MLJU 148	41
<i>National Steel & Shipbuilding Company v The United States</i> 190 Ct. Cl.247; 419 F 2d 863; 1969 US CtCl LEXIS 167	37, 38
<i>Olex Focus Pty Ltd v Skodaexport Co. Ltd</i> [1998] 34 NSWLR 243	42, 43

	PAGES
LIST OF CASES	
<i>Nene Housiong Society Ltd v National Westminster Bank Ltd</i> (1980) 16 BLR 22	2, 18
<i>Pembinaan Maluri Sdn.Bhd v Prudential Assuarncce Sdn.Bhd</i> [1991] 2 MLJ 350	18, 23
<i>Perar v General Surety & Guarantee Co. Ltd</i> [1994] 66 BLR 72	22, 23
<i>Preston Corp Sdn.Bhd v Edward Leong</i> [1982] CLJ 302; [1982] CLJ (Rep) 272	38
<i>Raymond Construction Pte.Ltd v Low Yang Tong & AGF</i> <i>Insurance (Singapore) Pte.Ltd</i> [1996] SGHC 136	6, 56, 32, 40, 72, 80
<i>Royal Design Studio Pte Ltd v Chang Development Pte.Ltd</i> [1991] 2 MLJ 229	60, 61, 62, 64, 80, 81
<i>Ryobi-Kiso (S) Pte.Ltd v Lum Chang Building Contractors Pte</i> <i>Ltd & Anor</i> [2013] SGHC 86	74, 75, 76, 77
<i>Satriasa Corporation Sdn.Bhd v Tenaga Nasional Bhd</i> [2010] 4 CLJ 877	20
<i>Sumatec Engineering & Construction v Malaysian Refining</i> <i>Co. Sdn.Bhd</i> [2012] 4 MLJ 1	7,48, 68, 70, 71
<i>Sumatec Engineering & Construction v Malaysian Refining</i> <i>Co. Sdn.Bhd</i> [Suit No.D-222 NCC-1123-2010]	7, 8, 69, 81
<i>Teknik Cepak Sdn.Bhd v Public Bank</i> [1995] 4 CLJ 697	17, 22
<i>The Radio & General Trading Co. Sdn.Bhd v Wayss &</i> <i>Freytagg (M) Sdn.Bhd</i> [1998] 1 MLJ 346	27, 40, 41, 62, 63, 64, 81
<i>Unitrack Building Construction Pte.Ltd v GHL Pte Ltd &</i> <i>Another</i> [1999] 3 SLR 621	66
<i>William v Walker-Thomas Furniture Co.</i> (1965) 350 F.2d 445, 449	31, 32
<i>Woodhall Ltd. v Pipeline Authority</i> (1979) 141 CLR 443	44
<i>Woodson (Sales) Pty v Woodson (Australia) Pty Ltd</i> [1996] Unreported, Supreme Court of New South Wales	30

LIST OF FIGURE

FIGURE NO.	TITLE	PAGE
1.1	Research methodology	13
3.1	Doctrine of unconscionability and the effect of its development	52
4.1	The list of the cases and the circumstances contended by the contractor as unconscionable conduct relating to call the performance bond	82-83

LIST OF ABBREVIATIONS

AC	Law Reports: Appeal Cases
AIR	All India Report
All ER	All England Law Reports
AMR	All Malaysia Reports
BLR	Building Law Report
CLJ	Current Law Journal (Malaysia)
CLR	Commonwealth Law Reports
Const LR	Construction Law Reports
ER	England Law Report
EWCA	England and Wales High Court
FMSLR	Federated Malay States Law Reports
HL	House of Lords
PWD	Public Works Department
LR	Law Reports
MLJ	Malayan Law Journal
PAM	Pertubuhan Arkitek Malaysia
PWD	Public Work Department (Malaysia)
QB	Queen' Bench
RIBA	Royal Institution of British Architects
RHC	Rules of High Court
SCR	Supreme Court Report
SLR	Singapore Law Report
WLR	Weekly Law Report

CHAPTER 1

INTRODUCTION

1.1 Background of study

Performance bond is a written declaration from an issuer¹ as a security to perform the contract, where a bond is a deed by which one person (the obligor) commits himself to another (the obligee) to do something or refrain from doing something.² It is one of the most important instruments in risk management perspective in construction industry especially from the employer's point of view.³

In *Teknik Cekap Sdn.Bhd v. Public Bank*, the judge has defined performance bond as follows:⁴

¹ Thanuja Rodrigo (2012) 'Unconscionable Demands Under On-Demand Guarantees : A Case of Wrongful Exploitation' 33 Adelaide Law Review p.482

² Elizabeth A Martin (2003), *A Dictionary of Law*, 5th Edition reissued with new covers, Oxford University Press, Oxford p.53

³ Abdul Aziz Hussin AMN [2011] "Unperformed Performance Bond In Construction Industry" Malayan law Journal Articles, p.1

⁴ [1995] 4 CLJ 697

“...a written contract of guarantee by a bank, other financial institution or in some cases an insurance company, whereby they guarantee the due performance of the contract in the event of a breach or non-performance of the contract, they guarantee to pay, on a written demand being made, the sum stipulated in the guarantee”

In Public Work Department (PWD) form 203A (Rev.1/2010), standard form of contract has stated that the performance bond can be in the form of Performance Guarantee Sum in lieu of the bank, insurance or finance company guarantee.⁵ The bond can be divided into two types. In the case of performance bond in construction industry, the type of bond normally found is the conditional bond.⁶

The employer shall be entitled at any time to call upon the performance bond, wholly or partially in the event that the contractors fail to perform or fulfil its obligation under the contract.⁷ In order to call for payment, the employer must provide the evidence of contractor's default and the losses suffered by the employer because of the default.⁸

The second type of the bond is unconditional or demand bond. The beneficiary is entitled to call upon the surety for payment whether or not there has been default under the principle contract.⁹

However, the contractor may apply for injunction against the employer to restrain the employer to call the bond. At English common law, the sole ground for restraining a beneficiary from calling on a performance bond or surety from paying out is fraud.¹⁰ In recent years, the concept of unconscionability as a ground for withholding payment in demand guarantees has been adopted.

⁵ Clause 13.2, PWD form 203A (Rev.1/2010), p.10

⁶ John Murdoch and Will Hughes [2008] *“Construction Contract : Law and Management”* 4th Edition, Taylor & Francis, Great Britain, p.245

⁷ PWD Form 203A (Rev.1/2010), clause 13.3, p.10

⁸ *Nene Housing Society Ltd v National Westminster Bank Ltd* (1980) 16 BLR 22

⁹ *Ibid*, Footnote 5

¹⁰ *Edward Owen Engineering Ltd v Barclays Bank International Ltd* [1978] QR 159

An injunction is a court order preventing someone from acting wrongfully (a “prohibitory” injunction) or ordering him to put right a wrong he has already committed (a “mandatory” injunction).¹¹ Injunction is an equitable remedy which statutory provided in Part III of the Specific Relief Act 1950.¹² In section 50 of Specific Relief Act 1950 stated that:¹³

“Preventive relief is granted at the discretion of the court by injunction, temporary or perpetual”

Injunction is granted at two (2) main stages. They are at trial (a “final” injunction) and when or immediately before the action begins (an “interim” or “interlocutory” injunction).¹⁴ The High Court jurisdiction to grant an injunction is provided under section 25(2) of the Court Judicature Act 1964 and the power of the court is discretionary.¹⁵ An application for injunction, as a general rule, would only be granted where damages would be an adequate remedy for the plaintiff.¹⁶

In recent years, the courts had dealt with the issue of the application for injunction against employer to restrain payment under a performance bond. One of the case deal with this issue is *Bocotra Construction Pte Ltd and Others v Attorney General (No 2)*.¹⁷

In this case, an arbitrator has made an interim order restraining the respondent from calling for payment on the guarantee. However, the respondent has sought and obtained a declaration that the arbitrator’s order was invalid and void. Due to that, the appellant sought to obtain an injunction against the effect which reflected those provided by arbitrator’s order. The

¹¹ Jonathan Leslie and John Kingston (1998) *“Practical Guide To Litigation”*, Travers Smith Braithwaite, London, p. 69

¹² A Mohaimin Ayus (2009) *“Law of Contract in Malaysia, Vol III : Discharge and Remedies”*, Sweet & Maxwell Asia, Malaysia, p.565

¹³ Section 50, Chapter IX, Part III, Specific Relief Act 1950.

¹⁴ Jonathan Leslie and John Kingston (1998) *“Practical Guide To Litigation”*, Travers Smith Braithwaite, London, p. 69

¹⁵ A Mohaimin Ayus (2009) *“Law of Contract in Malaysia, Vol III : Discharge and Remedies”*, Sweet & Maxwell Asia, Malaysia, p.565

¹⁶ Ibid, Footnote 13

¹⁷[1995] 3 LRC 423

judge has dismissed the application, holding that the guarantee was a demand bond and the proof of default was not required.

The appellant has appealed, contending that the guarantee was not a demand bond. Further, the appellant contended that on 'balance of convenience' test, since they might suffer irreparable damage to their reputation, due to call payment, the declaratory relief should be granted. The court has dismissed the appeal. The appellant failed to show the fraud or unconscionability and there was no apparent error to justify interfering with the trial judge's exercise of discretion not to grant the relief sought.

In other case, *Esso Petroleum Malaysia v Kago Petroleum Sdn Bhd*¹⁸, by applying 'balance of convenience' test, the appeal to set aside an injunction has been allowed. The respondent, *Kago Petroleum* had a contract with the appellant to sell and deliver certain construction material to Esso where the time is an essence to the contract. In the contract, if any delays in delivery by Kago, Esso would be entitled to deduct a maximum of 10% of the purchase price. However, at Kago's request, Esso paid the full price in exchange for two letters of guarantee (the performance bond).

Subsequently, the delay occurred and *Esso* claimed for damages due to the delay. *Kago* refuse to pay and Esso made a written demand on performance bond to Bank Bumiputera Malaysia Bhd. *Kago* had obtained an *ex parte* injunction restraining Esso from receiving any part of the moneys under the performance bond and alleged that the delays caused by *Esso*'s refusal to accept the goods and Esso had not indicated its intention to claim damages at the time of the acceptance of the delayed goods.

Esso's application to High Court to set aside the injunction was dismissed. Abdul Malek Ahmad J, in his judgment stated that, the defendant ('*Esso*'), had not proven any loss in their affidavits and that consequently no claim had ever been made against the plaintiff ('*Kago*').

¹⁸[1995] 1 MLJ 149

Besides that, the defendant, partly responsible for the delay and the defendant had not issued any notice of its intention to claim compensation at the time of delivery.¹⁹

Esso had appealed to the Supreme Court and the court had allowed the appeal.²⁰ In the judgment, the court says that, *Kago* was not prevented from applying for an interlocutory order against *Esso*. However, the ‘balance of convenience’ lay with the *Esso* as, inter alia, *Kago*’s remedy was in damage and *Esso* undoubtedly be able to pay.

As a conclusion, a court will grant the relief if the party able to convince that without the relief there will be irretrievable damages due to inadequate compensation.²¹ The assessment by the court must be based on affidavit evidence and it is sometimes difficult for the court to ascertain the truth on the basis of the evidence alone.²²

1.2 Problem Statement

Performance bonds are used frequently in the construction industry. The performance bond has resulted in substantial benefits to the parties. When the disputes arise, the court should give effect to the intentions of the parties. The law in relation to performance bonds should be placed on a clear and unambiguous footing.²³

The court has the power to grant or to refuse an application of injunction as per Court Judicature Act 1964 under section 25(2). Before granting an injunction, the court must make a

¹⁹[1994] 1 LNS 63

²⁰ *Supra*[1995] 1 MLJ 149

²¹ Dixon W.M (2004) “*As good cash? The Diminution of The Autonomy Principle*” Australian Business Law Review. 32(6), p.391-406. Accessed from <http://eprint.qut.edu.au>

²² Raymond Chan and Tan Joo Seng (1999) “*Uncosncionability prevent call on performance bond*”, accessed from <http://www.internationallawoffice.com/newsletter>

²³ *GHL Pte Ltd v Unitrack Building Constrction Pte Ltd and Another* [1998] 3 VR 380

decision affecting the rights of the parties without the opportunity of fully testing the disputed issues or evidence.²⁴

The ‘balance of convenience’ test has been considered by the court before granting or not granting an injunction. During this test, the court has to answer two (2) questions.²⁵ Firstly, will the defendant be adequately compensated by a later award damages if the injunction is subsequently held to have been wrongly granted because of the shortage of time and the absence of full evidence and argument? Secondly, will the plaintiff suffer greater harm by the refusal of an injunction if damages would not be an adequate remedy for the plaintiff?

As discussed in *Bocotra Construction Pte Ltd and Others v Attorney General (No 2)*²⁶ before, the Court of Appeal had dismissed the appeal by the appellant to obtain injunction against the effect which reflected those provided by arbitrator’s order. It has been stated in the judgment that the sole consideration for granting of injunction relief in cases involving performance bond and bank guarantee was presence of fraud and unconscionability. In this case, the ‘balance of convenience’ was superfluous. But, the judgment has stated that even if the ‘balance of convenience’ test were applicable, the appellant failed to show fraud or unconscionability and there was no apparent error to justify interfering with the trial judge’s exercise of discretion not to grant the relief sought.

Later, in 1996, in the case of *Raymond Construction Pte Ltd v. Low Yang Tong and AGF (Singapore) Pte Ltd*,²⁷ the court had granted an interim injunction solely on the ground of unconscionability. The plaintiff is a contractor engaged to build a house for the first defendant. The plaintiff had provided the first defendant a performance guarantee. The dispute arose and the first defendant called on the performance guarantee. The plaintiff obtained an injunction

²⁴ Jonathan Leslie and John Kingston (1998) “*Practical Guide To Litigation*”, Travers Smith Braithwaite, London, p. 74

²⁵ Ibid, Footnote 21

²⁶ *Supra* [1995]3 LRC 423

²⁷ [1996]SGHC 136

restraining the second defendant who is the guarantor from paying the first defendant and the first defendant from receiving the sum. *Lai Kew Chai J* has granted an interim injunction and had stated that:

“Unconscionability to me involve unfairness, as distinct from dishonesty or fraud, or conduct of a kind so reprehensible or lacking in good faith that the court conscience would either restraining the party or refuse to assist the party”

The doctrine of unconscionability is a creature of equity and its origin has been traced to the 17 century.²⁸ The term unconscionability is used in different ways by different judges and commentators to address fundamentally similar problem²⁹ that is unfairness³⁰

In the case of *Sumatec Engineering & Construction v Malaysian Refining Co Sdn Bhd*,³¹ the issue of unconscionability has been raised. The plaintiff was appointed by the defendant for the structural steel work contract. The plaintiff has provided a bank guarantee for the due performance of the contract for 10% of the contract value. The plaintiff claimed that their works were seriously hindered by delays on the part of defendant to supply complete drawings. The plaintiff had applied for injunction against the defendant to restrain the defendant from calling upon the bank guarantee. The plaintiff contended that the unconscionability in the conduct of the defendant related to the demand on the bank guarantee was a separate and distinct exception in addition to fraud. The court had allowed the plaintiff's application and the defendant had appealed.

²⁸ R.R Sethu “*Unconscionability equivalent to Actual Fraud?*”, CLJ Article [1983]1 CLJ 165

²⁹ SM Waddams “*Good Faith, Unconscionability and Reasonable Expectations*” (1995) 9 JCL 55,57

³⁰ Ibid, SM Waddams “*Unconscionability In Contracts*” (1976) 39 MLR 369

³¹ [2012] 4 MLJ 1

The Court of Appeal had allowed the appeal.³² The judgment had stated that the respondent had failed to adduce sufficient evidence of unconscionable conduct by the plaintiff. However, *Sumatec* had appealed to the Federal Court. Unfortunately, the appeal was dismissed.³³ In the judgment, the court said that the incidence raised by *Sumatec* of alleged unconscionable conduct on the part of *Malaysian Refining Co* (MRC) were factual matters which had been carefully evaluated and answered in the Court of Appeal. The learned judges rightly concluded based on the materials that unconscionability had not been proven to maintain the injunction granted. Further, the ‘balance of convenience’ favoured refusal of the injunction.

It is important for contracted parties to understand the use of the performance bond and the types of the bond provided in the contract. The fact that the beneficiary under a performance bond should be protected as to the integrity of the security he has in case of non-performance by the party on whose account the performance bond was issued is not deniable.³⁴ However, the performance bond can operate as an oppressive instrument in the event that a beneficiary calls on the bond in circumstance, where there is *prima facie* evidence of fraud or unconscionability.³⁵ Hence, a temporary restraining order does not prejudice or adversely affect the security but it merely postpones the realization of the security until the party concerned is given an opportunity to prove his case.³⁶

As mentioned earlier, in order to restrain the call of the performance bond, the sole consideration is the presence of fraud. However, in recent years, the scope of unconscionability has been accepted as a ground to restrain employer from calling the performance bond other than fraud. Unconscionability is a new development used by the court in granting injunction related to the matter of performance bond.

³² *Malaysian Refining Co Sdn Bhd v Sumatec Engineering & Construction* [2011] 7 CLJ 21

³³ *Ibid*, Footnote 28

³⁴ [1998] 3 VR 380

³⁵ *Ibid*, Footnote 33

³⁶ *Ibid*, Footnote 33

It is found that the term ‘unconscionable’ was not defined by Malaysian court³⁷ the principle underlying the unconscionability doctrine was the prevention of oppression and unfair conduct. The courts must consider such a claim on a case by case basis and assess the totality of the circumstances because the determination of unconscionability was fact-specific³⁸ the circumstances of the case seem to become the self-explaining factor for the finding of the unconscionable conduct.³⁹

1.3 Objective of Study

The objective of this study is to determine circumstances that amount to unconscionable conduct relating to call the performance bond.

1.4 Scope of study

The scopes of this study are:

1. The definition of ‘unconscionability’ based on the court’s interpretations that arise in the law of the contract.
2. This study is conducted by literature law cases using e-electronic sources from Lexis Malaysia to find out the information from Malayan Law Journal (MLJ), Malayan Law Journal unreported (MLJu), Malayan Law Journal Article (MLJA) and articles from seminar papers and previous research.

³⁷ Zahira bt Mohd Ishan (2007) “Unconscionable : Its Development and Possibilities” MLJ Article, [2007]3 MLJ xlv, p.8

³⁸ *Kejuruteraan Bintai Kindenko Sdn Bhd v Nam Fatt Construction Sdn Bhd & Anor* [2011] 7 CLJ 444

³⁹ Zahira bt Mohd Ishan (2007) “Unconscionable : Its Development and Possibilities” MLJ Article, [2007]3 MLJ xlv, p.8

1.5 Significance of study

Basically, this study was conducted to give insight of the doctrine of unconscionability which was used by the court in granting or rejecting an application of injunction. It is hoped that the contracted party especially parties involve in construction contract will get clear explanation about unconscionability and the circumstances that considered as unconscionable in application of injunction.

1.6 Research Methodology

In achieving the intended objectives of the study, this research process comprise of four (4) major stages as follows:-

1.6.1 Stage 1 – Development of Proposal

1.6.1.1 Identifying the Research Issue

The initial stage involves the identification of research issues as well as formulating research objective. The initial literature review will be done to overview the concept of this topic. Once research objective has been formulated, the scope for the research will be determined as well as the research title.

1.6.1.2 Literature Review

Collection of various documentation and literature regarding the study field is of most important in achieving the research objectives. Data will be collected mainly through documentary analysis. All collected data and information will be recorded systematically. Data will be collected mainly from Malayan Law Journal, Singapore Law Report, Building Law Report, Construction Law Report and other law journals. Data is collected by browsing through the LexisNexis legal database. Important and relevant cases will be collected and used for the analysis at the later stage. In addition, secondary data from books, article reports, seminar papers, newspapers and articles from the internet, is also useful for this research. All the relevant books will be obtained from the Universiti Teknologi Malaysia library and other public libraries.

1.6.2 Stage 2 – Data and Information Collection

1.6.2.1 Data Collection

At this stage, all the collected data, information, ideas, opinions and comments will be arranged and recorded systematically. Important and relevant cases is collected and use for the analysis at the later stage.

1.6.3 Stage 3 – Data Analysis

1.6.3.1 Data Analysis

The third stage of research is analysis phase. It involves data analysis, interpretation and data arrangement. Once the previous related court cases are collected, reviewing and clarifying all the facts of the cases will be conducted. The focus will be on the issue of this research. After identifying issues in each case, a thorough discussion and comparison will be done in order to achieve objectives of this study.

1.6.4 Stage 4 – Conclusion and Recommendation

1.6.4.1 In this final stage, discussions will be done based on the findings from the previous stage to fulfill the aims or objective of this research and reach a conclusion. Recommendations for further research will be made as a suggestion for future researcher.

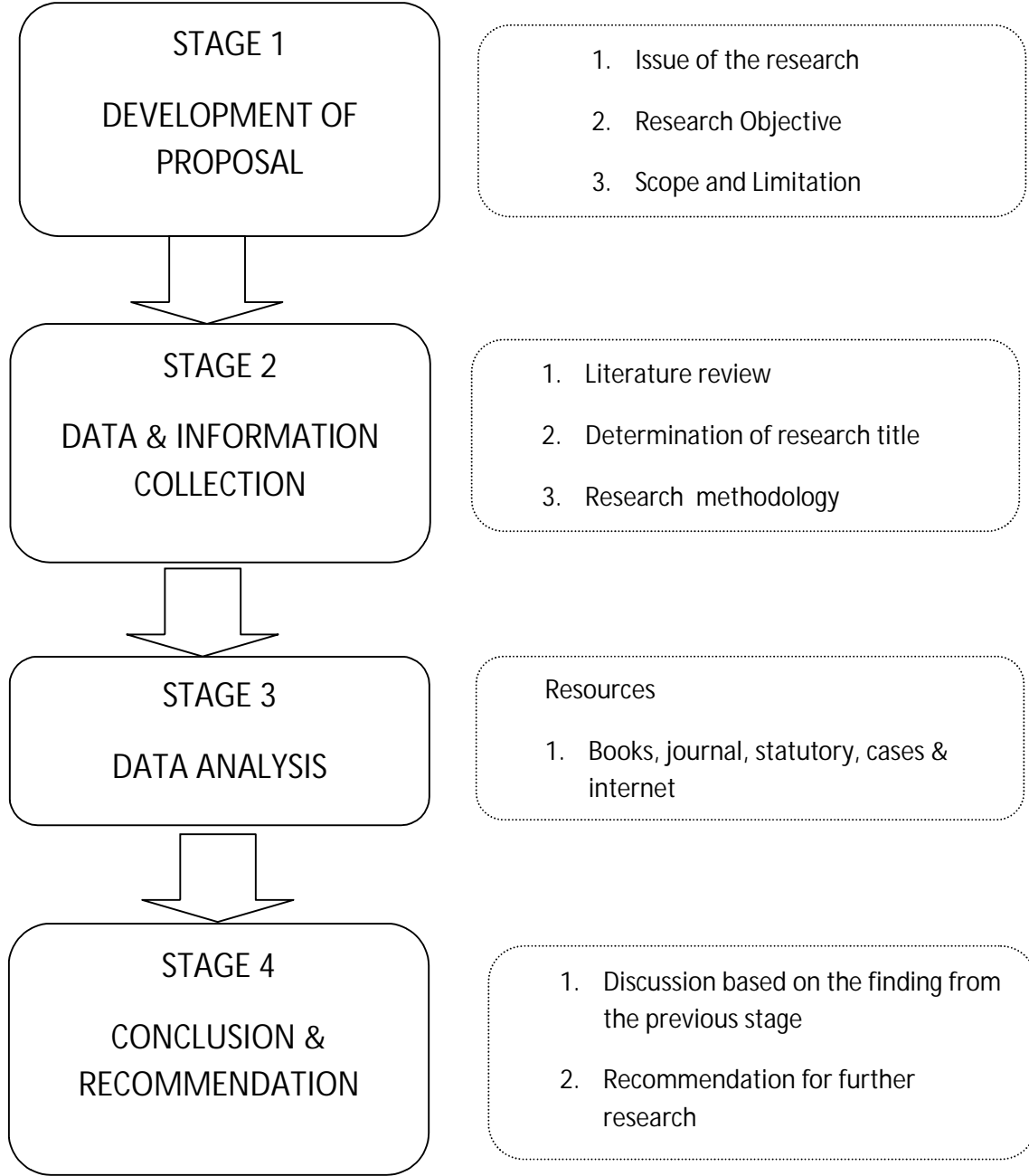


Figure 1.1: Research Methodology

1.7 Organisation of the study

1.7.1 Chapter 1 – Introduction

This chapter contains a discussion on the issues related to the performance bond, application of injunction against the employer and briefly discussed about the doctrine of unconscionability. Besides that, this chapter also shows the development process of research start from the objectives, scope and the methodology

1.7.2 Chapter 2 – Performance bond and Injunction

This chapter explains about the principle of performance bond including the used and the rights of the contracted parties against the performance bond when the breach of contract occurs. Discussion will be focused on the calling the bond and application of injunction against the Employer whether to restrain from calling the bond or receiving the payment of the bond.

1.7.3 Chapter 3 – Doctrine of Unconscionability

This chapter explains about the history of the doctrine of unconscionability and its development in common law jurisdiction. Discussed in detailed about the definitions and the related cases regarding to the application of injunction under the ground of unconscionability.

1.7.4 Chapter 4 – Unconscionability as a ground for application for injunction

This chapter focuses on the cases related to unconscionability as a ground for application for injunction. The analysis will be focused on the court's interpretation about the doctrine of unconscionability before granting or rejecting the application for injunction.

1.7.5 Chapter 5 – Conclusion

This last chapter will explain about the summaries of all major findings, recommendations and conclusion of the study.

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