

PERFORMANCE BOND AND AN INJUNCTION

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

Faculty of Built Environment
Universiti Teknologi Malaysia

July 2007

To my family for their love and support

ACKNOWLEDGEMENTS

With high gratitude to Allah S.W.T. who gave me the ideas and physical strength in preparing this master project. Along the master project completion, the author cannot efforts own selves without supporting and encouraging for the others parties. Because of that, I wish to express my thankful to the persons and all parties who involved in this research and offered a valuables cooperation in carrying out this final project.

First of all, I would give my acknowledgement to my supervisor En Jamaluddin Yaakob for his guidance, support and giving the ideas in preparing of this master project.

My appreciation also goes to all the lecturers for the course of Master of Science in Construction Contract Management, for their patient and kind advice during the process of completing the master project.

I am also thankful to my parents for their helpfulness and encouragement while preparing this master project.

Lastly, I would like to thank my classmates for giving me morale support and supplying me with the information on how to write a master project.

Thank you for all participants whose have give a lot of uproot that I really need in completing the master project.

ABSTRACT

Claims under performance bonds have been a subject of considerable litigation in Malaysia and other jurisdictions. Performance bonds, either conditional or on-demand, are provided by contractors in favour of employers to ensure their complete performance of the contracts. When the contractors breach the contracts, this will entitle the employers to make calls on the bonds. However, injunctions have been used by contractors to defeat the main purpose of the bonds. Injunction is an equitable remedy and is within the discretionary power to the judge. Judges have granted and rejected contractors applications for injunction to restrain the call on the bonds. The main issue is relating the principles used by judges in granting or rejecting an injunction. 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 the bonds. The research methodology used in achieving this objective, was by analysis of reported and unreported court decisions of the relevant leading cases in Malaysia and other commonwealth countries. The analysis showed that: there three principles in refusing and two principles in granting an application for an injunction. The two principles for granting an injunction are fraud or unconscionably conducts regarding the making of the call or payment. The three principles for refusing are one, when there are serious issues to be tried; two, when fraud is involved; and here, when there is unconscionably conduct by contractors. However, if the court identified that there is an adequate remedy the injunction will not be granted. As conclusion, injunction to restrain the calling and obstructing the payment is not an appropriate method in solving disputes that arise between two parties. It is better to identify other alternative adequate remedies recovering the financial loss and damages.

ABSTRAK

Tuntutan di bawah bon pelaksanaan adalah subjek yang sebahagian besar dipertimbangkan dalam pendakwaan mahkamah sama ada di Malaysia mahupun bidang kuasa dari negara lain. Bon pelaksanaan sama ada bersyarat atau tidak bersyarat, diberikan oleh kontraktor atas permintaan majikan untuk memastikan persembahan kontrak mereka sempurna. Apabila kontraktor telah melanggar kontrak, ini memberi peluang kepada majikan untuk membuat panggilan terhadap bon. Oleh itu, injuksi digunakan oleh kontraktor untuk memintas tujuan utama bon pelaksanaan. Hakim telah memberikan dan menolak permintaan kontraktor untuk menghalang panggilan bon. Isu yang utama berkaitan dengan prinsip yang digunakan oleh hakim untuk memberikan dan menolak injuksi. Tujuan kajian ini adalah untuk mengenalpasti prinsip undang-undang dalam permohonan injuksi untuk menghalang proses panggilan bon dan penerimaan pembayaran bon pelaksanaan. Kaedah kajian dikendalikan untuk mencapai tujuan kajian ini adalah dengan membuat analisa terhadap keputusan kes-kes mahkamah yang dilaporkan atau tidak yang berkaitan dengan kes-kes utama dalam negara Malaysia dan dari negara-negara komanwel yang berkenaan. Analisis menunjukkan bahawa; terdapat tiga prinsip menolak dan dua prinsip memberi untuk permohonan injuksi. Dua prinsip untuk pemberian injuksi adalah penipuan atau indakan yang tidak patut yang berdasarkan panggilan bon dan pembayaran. Terdapat juga tiga prinsip menolak injuksi iaitu; apabila ada isu-isu yang serius untuk dibicarakan; apabila penipuan terlibat; dan tindakan yang tidak patut oleh kontraktor. Walaupun begitu, sekiranya mahkamah mengenal pasti terdapatnya remedi-remedi yang memuaskan, injuksi tidak akan diberikan di bawah bon pelaksanaan. Kesimpulannya, injuksi untuk menghalang panggilan dan menyekat pembayaran adalah bukan kaedah yang terbaik untuk menyelesaikan perselisihan paham antara kedua-dua pihak. Adalah lebih baik mengenalpasti remedi-remedi yang memuaskan untuk memulihkan kerugian dan kerosakkan.

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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

Claims under performance bonds or guarantees are frequently the subject of litigation in Malaysia.¹⁶⁸ This is due to the fact that in most of the local standard forms of building contract, the performance bond and / or bank guarantee being one of the mandatory conditions upon the award of the contract.¹⁶⁹

Performance bond and guarantees are intended to provide assurance to the owner of a project that the project will be completed.¹⁷⁰ Regardless of the reason, if the main contractor fails to fulfill its contractual obligations, the owner, and those referred as insured or obligee, is protected by the surety against loss up to the amount of bond penalty.¹⁷¹ Beside that, there are two significant benefits of performance bond i.e. the

¹⁶⁸ Powell-Smith, V. (1992). Calls on Performance Bond in Malaysia-The Current Law. *The Malayan Law Journal Articles*. Vol. 2.

¹⁶⁹ Ho Sook Chin, *To Have and To Hold: Performance Bonds and Bank Guarantees*, Available in Construction News & Views, The Quarterly Newsletter of JUBM & DLS, Issue 1 June 2006

¹⁷⁰ *How the owner derives benefit from a performance bond*. Published date on July 05, 2000. Available in <http://www.reedsmith.com>.

¹⁷¹ Bockrath, J. T. (2000). *Contracts and Legal Environment for Engineers & Architects*. 6th Edition. United State: McGraw Hill Companies, Inc.

third party legal promise of strong financial standing and the right to immediate and unconditional payment where the payment obligation almost as good as cash.¹⁷²

In the current state of the construction industry, performance bonds are here to stay, but there are possible pitfalls when the time comes to call on the bond. The call on the bond as set out in that bond itself with order to be entitled for payment.¹⁷³ If the parties in dispute, before the dispute resolved, whether or not the prime contractor has performed its obligations under the contract and the client makes a call off the bonds.¹⁷⁴

A demand or call for payment under performance bond is almost predictable with preceeding for injunction relief¹⁷⁵ if there are any protests or any contestation from contractor or subcontractor to refrain the employer or contractor from gaining the benefits in performance bond. In case of *LEC Contractors (M) Sdn. Bhd. V. Castle Inn Sdn. Bhd.*¹⁷⁶ the wordings of the bond herein this case read as follow:

*“If the Contractor (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 his obligations thereunder then the Guarantor shall pay to the Principal up to and not exceeding the sum of Ringgit Malaysia: Four Million Eight Hundred Thousand only (RM4.8,) representing 5% of the Contract value or such part thereof, on the Principal’s written demand notwithstanding any contestation or protest by the Contractor or by the Guarantor or by any other third party.”*¹⁷⁷

¹⁷² Low Kee Yang, (2003) *The Law of Guarantees in Singapore & Malaysia*, 2nd Edition, Singapore: LexisNexis Butterworth.

¹⁷³ Micheal Teoh, *Understanding Bonds and Guarantee Provisions in Construction Contracts* in Construction Contract Conference on 29-30th September 2003 at Kuala Lumpur.

¹⁷⁴ Ibid, Footnote 2.

¹⁷⁵ Ibid, Footnote 6.

¹⁷⁶ [2000] 3 MLJ 339

¹⁷⁷ At page 347 of the judgment.

From the stated case above, a party may seek to injunctive relief when there are legal suit to be brought forward to the court.¹⁷⁸ The subject to injunctive relief on performance bond is a complex and controversial one. This is because, injunction in performance bond occurred wherein surety party in arrangement of bond calling and acquired injunction order from the main purpose is to withhold the payment of performance bond to beneficiary.¹⁷⁹ Different approaches have been used by the courts to lessen the severe impact in any of misjudged cases.¹⁸⁰

By examining the principal's perspective and the call had been made by the beneficiary, the court will provide clarification on whether to award injunction or not. 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.¹⁸¹ Beside that, the injunction will be given if it is in exceptional circumstances where the courts will interfere with the machinery of irrevocable obligations assumed by banks.¹⁸² Fraud has been ruled to be an instance of such exceptional circumstances.¹⁸³

¹⁷⁸ The issues will depend on the facts of the case; the construction of the performance bond and the contract. See in *Esso Petroleum Malaysia Inc. v. Kago Petroleum Sdn. Bhd.* [1995] 1 MLJ 149 and *American Cyanamid Co. v. Ethicon Ltd* [1975] AC 396

¹⁷⁹ Abdul Aziz Hussin & Abdul Rashid Abdul Aziz. (2001). *Undang-undang Pembinaan: Bon-bon Gerenti dalam Kontrak Pembinaan*. Pulau Pinang: Penerbit Universiti Sains Malaysia.

¹⁸⁰ Ibid, Footnote 5.

¹⁸¹ Dixon. W. M. (2004) As good cash? The Diminution of the Autonomy Principle. *Australian Business Law Review*. 32(6): pp. 391-406. Accessed from <http://eprints.qut.edu.au>.

¹⁸² *Siemens Integra Transportation System Sdn Bhd & Anor v. EKD Construction Sdn Bhd & Anor*[2003] MLJU 475

¹⁸³ See *Esso Petroleum Malaysia Inc. v Kago Petroleum Sdn. Bhd.* [1995] 1 MLJ 149.

1.2 Problem Statement

As discussed above, it shows how importance for having bonds and guarantee in construction contract. The purpose of holding a performance bond is to provide assurance that in the event of insolvency of, or default by, the contractor during the construction, the employer may secure payment or compensation from the solvent (and substantial) paymaster. Hence it is sometimes called “performance security”. It is obvious that any performance bond worth having should be in the form of an “irrevocable unconditional (or on-demand) bank guarantee”, on the premise that such instrument is “as good as cash in hand”.¹⁸⁴

However, performance bond or performance guarantee has been the subject of considerable litigation in recent years from any jurisdictions and in Malaysia. Several issues¹⁸⁵ arise within the disputed cases are as follows: (1) whether an instrument is a conditional or an on-demand bond; (2) the effect of failure on the part of the beneficiary to give notices; (3) availability of an injunction to restrain the surety from paying after a call has been made by the beneficiary; (4) availability of an injunction to restrain a beneficiary from receiving payment after a demand has been made; (5) availability of an injunction to restrain a beneficiary from making claim; (6) availability of a Mareva injunction to freeze a call; (7) meanings of certain phrases used in the instruments; and (8) a duty to account for proceeds of a call. Out of four from the stated issues above, indicates that injunction is the considerable issue in determining any relationship with the performance bond.

¹⁸⁴ Ibid, Footnote 2.

¹⁸⁵ Issaka Ndekugri. (1999). Performance Bonds and Guarantees: Construction Owners and Professionals Beware. *Journal of Construction Engineering And Management*. 125(6): 428-436

These issues arose because the possession of knowledge of the issues and principle should enable the construction and engineering industries and their legal advisers to better prioritize on which matter require extra attention in the drafting and negotiation of these instruments. Therefore, non-ambiguous legal principles should also contribute to reduction in litigation.¹⁸⁶ In recent years, surety companies, contractors, and owners have struggled over the definition of the rights and liabilities flowing from performance bonds and every construction industry participants are advised to develop sufficient basic understanding of the rights and potential liabilities associated with the performance bond.¹⁸⁷ Under such circumstances, an understanding of the legal principles involved is crucial.

The discussions highlighted on the situation where the injunction applied by the party which have the equity interest on performance bond. Injunction arose when an improper conduct by a beneficiary of an on-demand performance bond i.e., calling the bond when there has been no breach or when he himself in breach of the underlying contract is apparent. For reasons of simplicity, on-demand performance bonds are hereafter referred to as performance bonds. The issuer is assumed to be a bank for the same reasons and the fact that it is the most common practice. It is also to be noted that in some of the cases to be referred to, although the judgments referred to performance guarantees, the instruments involved were performance bonds.¹⁸⁸

Since the injunction have given significant impact to the purpose of performance as a financial security to beneficiary, these question drag various inquiries such as; Whether the injunction is the best way to restrain the beneficiary to gain the benefits where there is existence of default from beneficiary or principal itself? Will the performance bond's privilege being challenge by applying the injunction relief from the

¹⁸⁶ Ibid, Footnote 18.

¹⁸⁷ Smith, Currie & Hancock LLP's, (2001), *Common Sense Construction Law, A Practical Guide for the Construction Professional*, New York: John Wiley & Sons, Inc.

¹⁸⁸ Ibid, Footnote 18.

court? And it is very vital to know how the legal interpret the principles of injunction granting in the performance bond? Thus, the above-mentioned questions are useful as the foundation of this research in searching the most relevant answers to those questions.

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

1.3 Objective of Topic

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. The objective of the topic is spelt out through the analysis made on the common issues disputed throughout problem statement above.

1.4 Scope of Topic

The examination is based on cases related to building contract and any circumstances arising thereof, in connection to the building contract. Beside that, the cases selected which decided from by Malaysian courts. However, there are frills with relevant cases from other jurisdiction.

1.5 Significance of Topic

This study is hoped to give brief information on the bond application, management and its effectiveness in construction contract practice in order to be a reference to the Malaysian construction contract practice. Once they understand the basic principles, and realize their rights and liabilities in performance bond when the time of calling or receiving payment, the potential dispute might reduce.

Beside that, it is significant if this study could identify the problems and recurring issues in court cases regarding bonds and guarantees in injunction relief to restrain the payment of bond and determining the principles involved in the court judgment.

1.6 Methodology and Research Process

In order to fulfill all the objectives of this topic, the method that need to be taken had been recognized and planned. All methods have been divided into stages as assessment of this research as shown in *Chart 1.1*. Beside that, the research process on this report generally consists of four (4) stages, i.e. 1st stage: Analysis of the problem, 2nd stage: Identification of issues commonly in dispute, 3rd stage: Finding of primary sources of relevant law and 4th stage: In-depth examination of the individual cases to extract the relevant legal principles.

1.6.1 Problem Analysis

As a necessary precondition, the basic concepts relevant to the study had to be understood. This understanding was acquired from textbooks, journals or any printed

sources. The subject of guarantees and bonds is still very specialized. Good understandings of the basic concepts to be used to refer to specific aspects were examined. The terms available in such as “contract,” “guarantee,” “bond,” “performance guarantees,” “performance bond,” “security,” “performance security,” “banking,” “suretyship,” and “construction law.”

The information and data of this research will be obtained and collected from the analysis. Mostly the research will exercise the resources from two (2) basic types of sources. There are:

1.6.1.1 Primary Data

Primary data collected mainly from Malayan Law Journal, Singapore Law Report, Building Law Report, Construction Law Report and other law journals. It is collected through the LexisNexis law database. All the cases relating to the research topic will be collected in order to identify the problems and the recurring issues related to bonds and guarantees in Malaysia and overseas construction contracts.

1.6.1.2. Secondary data

Secondary research data will be retrieved from the books, standard form of building contract, articles and journals, seminars papers as well as Internet websites. These sources are important to complete the literature review chapter.

All the data that have been obtained will be systematically analyzed, interpreted, arranged and write up.

1.6.2 Identification of Disputed Issues

The present stage was essentially a formalization of the issue identification process through references to relevant law reports and articles in journals. The use of indexes of legal journals and law reports ensured the identification of every relevant case and article.

The issues most commonly raised in litigation have two main sources. The first concerns the interpretation of the particular instrument, i.e., the nature and extent of the obligations undertaken by the bondsman or surety, whereas the second is about the circumstances in which a court may restrain a claim on the instrument or dealing with the proceeds of a successful claim.

1.6.3 Identification of Relevant Case Law

The outcome of the earlier stages was identification of the relevant questions and the establishment of trails of the law on each issue in the form of some relevant cases. Citatory were used to identify subsequent cases in which each case already identified was affirmed, applied, approved, considered, disapproved, distinguished, doubted, explained, extended, followed, not followed, overruled, referred to, or reversed.

1.6.4 In-depth examination of the individual cases to extract the relevant legal principles.

Then, each case examined to extract the relevant legal principles accordance to the objective of this report. It mainly involves analyzing and writing.

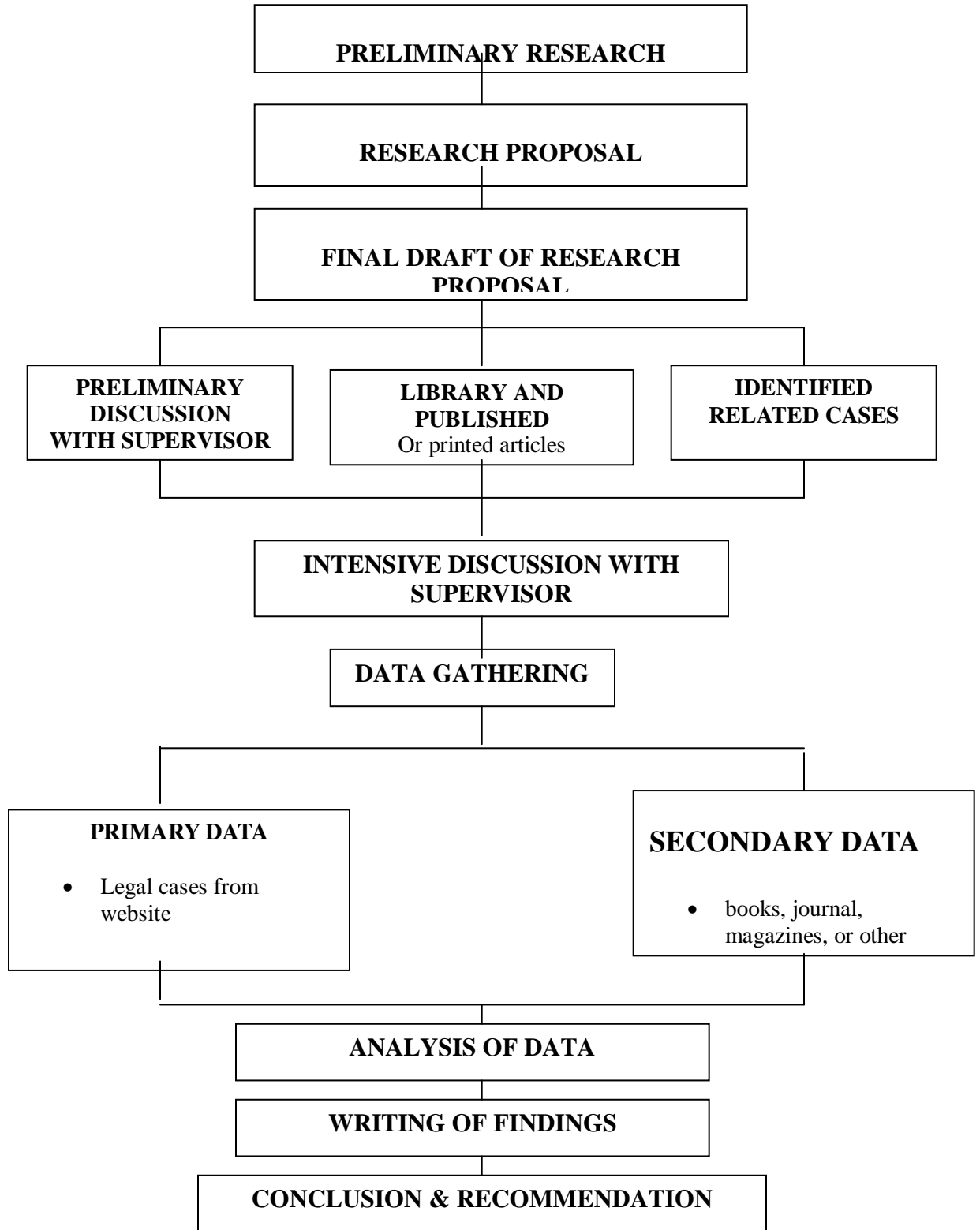


Chart 1.1. Flow Chart of Methodology

1.7 Terminology

The following terms used frequently in this project report. Therefore, to preventing any misunderstanding and give benefit to non-legal readers, terminology is helping.

1.7.1 Surety¹⁸⁹

Webster's Dictionary defines surety as, "The state of being sure; A pledge or other formal engagement given for the fulfillment of an undertaking; the one who has become legally liable for the debt, default, or failure in duty of another."

The Surety Association of America (SAA) has defined a surety bond as, "An agreement providing for monetary compensation should there be a failure to perform specified acts within a stated period."

1.7.2 Guarantees¹⁹⁰

A guarantee has been defined as an accessory contract by which the promisor (the guarantor) undertakes to be answerable to the promisee (the creditor) for the debt, default, or miscarriage of another person (the debtor), whose primary liability must exist or be contemplated (Halsbury's 1993).

¹⁸⁹ Roozbeh Kangari. & Moataz Bakheet. (2001). Construction Surety Bonding. *Journal Of Construction Engineering And Management*. 127(3): 232-238

¹⁹⁰ Ibid, Footnote 18.

1.7.3 Bonds¹⁹¹

A bond is a promise by deed by one party to pay another a sum of money. A guarantee executed as a deed in which the guarantor undertakes to answer for the debt, default, or miscarriage of another by a monetary payment is therefore a bond. The bond may make payment unconditional, i.e., payment must be made on a demand by the promise or it could be conditional on defined events. The former type are referred to as a “first conditional bond” or an “on demand bond,” whereas the latter type is called a “conditional bond.”

In practice, a conditional bond is commonly referred to as a guarantee or performance guarantee, whereas the terms “performance bond” or even just “bond” is reversed for unconditional bonds.

1.7.4 Synonymous Title of Parties Involved¹⁹²

1. “Guarantor”, “Surety”, “Bondsman”, “Obligor”, (and in the case of some “on demand” or letter of credit situations “Bank” or “Issuing bank”.
2. “(principal) Creditor”, “Obligee”, and, in some “on demand” situations, “Beneficiary” (who in the case of performance as opposed to payment bonds will normally be the construction owner, or in the case of some sub-contracts the employing main contractor).
3. “(principal) Debtor”, “Principal”, that is, the party whose obligation is guarantees, in performance bond, this will be the contractor or sub-contractor.

¹⁹¹ Ibid, Footnote 18.

¹⁹² Wallace, I.N.D. (1995). *Hudson’s Building and Engineering Contracts: Including the Duties and Liabilities of Architects, Engineers and Surveyors*. 11th Edition. Vol. 2. London: Sweet & Maxwell Limited.

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