

Performance Bonds Still As Good As Cash?

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English common law is one of the most prevalent and influential legal traditions of the world. Many jurisdictions that were once British colonies have adopted the common law system. Notwithstanding the proliferation of enacted legislation and administrative rules and regulations, case law remains a bedrock of fundamental legal principles within common law systems. English case law, not unexpectedly, is highly persuasive in the development of such case law in many jurisdictions and is often the root for establishing general legal principles across jurisdictions.

However, it is not safe to assume that all common law jurisdictions apply the same legal principles in the same way. Courts have often exercised flexibility and boldness in developing different ways of applying such principles in their respective jurisdictions. One such example can be observed in the treatment of on-demand performance bonds in relation to the use of the defence of 'unconscionability' to restrain payment on such bonds.

Use of Performance Bonds

Performance bonds are a common prerequisite requested by employers to most construction projects as security for a contractor's performance during the construction and/or maintenance periods. Performance bonds largely exist in two classifications, namely, 'on-demand' bonds where the beneficiary can demand for payment without being required to prove that the contractor is in breach of his or her obligations and 'conditional' bonds where some pre-determined event

must have occurred prior to the beneficiary being entitled to payment. Employers will usually seek, and contractors will almost inevitably agree to provide, the former, which are typically issued by a bank. Contractors have often approached the courts to seek injunctive relief to restrain employers from unfairly exercising their right to receive payment under these on-demand bonds.

English Position

For many years, the English courts had maintained a high burden for any claimant seeking an injunction in relation to an on-demand bond. It was recognised in *Edward Owen*¹ that performance bonds stand on a similar footing to a letter of credit and the bank must pay according to its guarantee, on demand, if so specified, without proof or conditions. On-demand bonds have been acknowledged by the judiciary as the "life-blood of international commerce".² As such, historically, the English courts have not impeded a

¹ *Edward Owen Engineering Ltd v Barclays Bank International Ltd* [1978] 1 All ER 976

² *Kerr J in RD Harbottle (Mercantile) Ltd v National Westminster Bank* [1978] QB 146 at p 155

bank's obligation to make payment on grounds that do not concern the credit. The wholly exceptional case where an injunction may be granted is where the bank is proven to know that any demand for payment already made, or which may thereafter be made, will clearly be fraudulent. This is known as the 'fraud exception'.

Pivoting slightly from the bright-line rule that only the fraud exception applies, the English courts have subsequently, over the years, recognised that payment under a demand on a bond may be restrained if the underlying contract expressly prohibits the making of the demand. This was articulated in *Sirius*³ and elaborated further in *Simon Carves*⁴ where the court adopted standards that were more familiar to other interim injunction applications and did not hesitate to make an assessment of the underlying merits of the application.

Home ground

In Malaysia, the Federal Court's decision in *Esso Petroleum*⁵ adopted the English law position in *Edward Owen* that an injunction to restrain a call on an on-demand bond would only be granted where fraud is established. However, in *Sumatec Engineering*,⁶ the Federal Court then recognised 'unconscionability' as a "separate and independent ground" to allow a restraining order on the beneficiary on the basis that this exception stems from the general concept of equity that a person should not be allowed to use his legal rights to take advantage of another's



special vulnerability or misadventure for the unjust enrichment of himself.⁷

The unconscionability exception was explained by the Court of Appeal in *Sumatec*⁸ to be in, *inter alia*, the following terms:

- 1) it should only be allowed with circumspect where events or conduct are of such a degree such as to prick the conscience of a reasonable and sensible man;
- 2) what would be considered unconscionable conduct would have to be determined on a case-by-case basis;
- 3) unconscionable conduct would always involve an element of unfairness or some form of conduct which appears to be performed in bad faith; and
- 4) a clear case of unconscionability must be established, and mere allegations are insufficient.

The principles laid down in *Sumatec* were subsequently applied in a long line of cases⁹ within the country. Rather than an exclusive emphasis on the value of certainty, Malaysian courts have appeared to adopt a more fact-sensitive approach to safeguard the obligor of a performance bond from abusive calls on the bond.

³ *Sirius International Insurance Co v FAI General Insurance Limited* [2003] 1 WLR 2214

⁴ *Simon Carves Ltd v Ensus UK Ltd* [2011] BLR 340

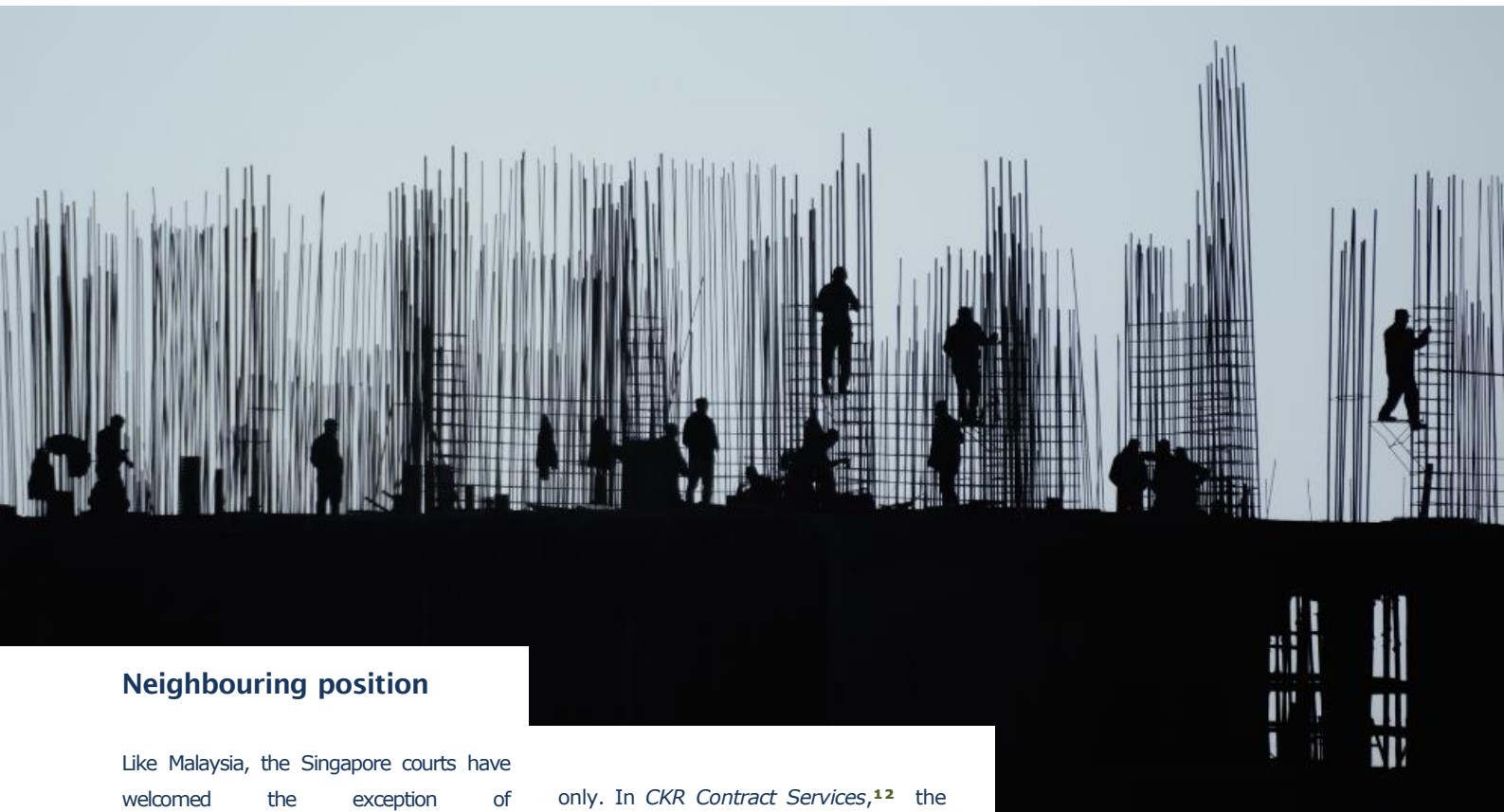
⁵ *Esso Petroleum Malaysia Inc v Kago Petroleum Sdn Bhd* [1995] 1 CLJ 283

⁶ *Sumatec Engineering & Construction Sdn Bhd v Malaysian Refining Company Sdn Bhd* [2012] 3 CLJ 401

⁷ See *Stern v McArthur* (1988) 165 CLR 489

⁸ *Malaysian Refining Company Sdn Bhd v Sumatec Engineering & Construction Sdn Bhd* [2011] 7 CLJ 21

⁹ This includes *Maxwell Accent JV Sdn Bhd v Kuala Lumpur Aviation Fuelling System* [2017] 1 LNS 990; *Dunggun Jaya Sdn Bhd v Aeropod Sdn Bhd & Anor* [2017] MLJU 1225; *KNM Process Systems Sdn Bhd v Lukoil Uzbekistan Operating Company LLC* [2020] MLJU 85



Neighbouring position

Like Malaysia, the Singapore courts have welcomed the exception of unconscionability. In *Bocotra*,¹⁰ the Singapore Court of Appeal opened the door to unconscionability by alluding to 'fraud or unconscionability' as a ground for injunctions on performance bonds. It was later affirmed in *GHL Pte Ltd*,¹¹ that unconscionability involves unfairness, a separate notion from dishonesty or fraud, or conduct of a kind so reprehensible or lacking in good faith that a court of conscience would not proceed to assist the party.

Although the Singapore courts have accepted the unconscionability exception, it is interesting to note that they have also provided an avenue to sidestep the exception by holding that parties to an agreement may agree to limit the circumstances in which a contractor is entitled to seek an injunction restraining a call on a performance bond, i.e. to fraud

only. In *CKR Contract Services*,¹² the construction contract between the developer of a residential project and its main contractor contained a clause that the contractor was not entitled to restrain the developer's call on the performance bond on any ground except in the case of fraud. The Singapore Court of Appeal held that the clause was akin to an exemption clause and found no reason to find the clause unenforceable.

The decision in *CKR Contract Services* is not unexpected given that it came at the heels of an earlier decision of the Singapore High Court in *Shanghai Electric*¹³ which in effect allowed the parties to try and contract out of the unconscionability exception by providing for the performance bond to be governed by English law, under which unconscionability is not a bar to calls on the bond.

The URDG 758

Separately from the choice of governing law, the use and incorporation of the Uniform Rules for Demand Guarantees (URDG) 758 ("**URDG 758**") into the terms of the bond could add a further complication. In *Leonardo*,¹⁴ the Qatar Financial Centre court considered both the impact of incorporating the URDG 758 into on-demand bonds, especially for international projects, and the defence of unconscionability.¹⁵ Even though the court recognised the adoption of the doctrine in some jurisdictions, it held that the whole commercial purpose of on-demand bonds is for the beneficiary to obtain immediate relief and to avert the need to enter into disputes arising from the underlying contract.

¹⁰ *Bocotra Construction Pte Ltd & Ors v Attorney General (No. 2)* [1995] 2 SLR 733

¹¹ *GHL Pte Ltd v Unitrack Building Construction Pte Ltd* [1999] 3 SLR (R) 44

¹² *CKR Contract Services Pte Ltd v Asplenium Land Pte Ltd and another and another appeal and another matter* [2015] SGCA 24

¹³ *Shanghai Electric Group Co Ltd v PT Merak Energy Indonesia & Anor* [2010] 2 SLR 329

¹⁴ *Leonardo S.p.A v Doha Bank Assurance Company LLC* [2020] QIC (A) 1 (on appeal from [2019] QIC (F) 6)

¹⁵ The URDG 758 are only applicable if the parties to an on-demand bond incorporate the URDG 758 into the bond.



The court opined that while fraud may operate as an exception to the general rule, wider exceptions should not be encouraged.

The core principle of the URDG 758 is that the bond should be autonomous from the terms in the underlying contract which means that the circumstances giving rise to the obligation to pay should be found exclusively in the bond. Under the URDG 758, the guarantor should only be concerned with the issue of whether the documents presented comply with the terms and conditions of the guarantee and not whether the goods and services conform with the underlying contract. It appears that the application of the URDG 758 would make it less likely that the unconscionability exception will apply. The further question then is whether this will remain the position where the URDG 758 is incorporated into an on-demand bond and at the same time the underlying contract expressly prohibits the making of the demand, as described earlier in *Simon Carves*.¹⁶

Takeaway

Whilst the courts in common law jurisdictions are inclined to accept the notion that an on-demand bond should be “*as good as cash*”, there have been circumstances where a more liberal approach has been adopted. Parties are encouraged to be alive to the distinctions between jurisdictions, both when negotiating the governing law and terms of a performance bond, and when evaluating whether to apply for, or to resist, an injunction against a call on such bond.

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¹⁶ *Simon Carves Ltd v Ensus UK Ltd* [2011] BLR 340