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Construction Industry Development Board

2009

Online at <https://mpra.ub.uni-muenchen.de/34007/>
MPRA Paper No. 34007, posted 10 Oct 2011 10:43 UTC

PERFORMANCE BOND: CONDITIONAL OR UNCONDITIONAL

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Abstract:

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

Keywords: Performance Bond, Guarantees, Conditional, Unconditional

1. INTRODUCTION

A performance bond is a bond giving security for the carrying out of a contract, where a bond is a deed by which one person (the obligator) commits himself to another (the obligee) to do something or refrain from doing something (Martin, 2003). In construction contracts, a 'performance bond' is a bond taken out by the contractor, usually with a bank or insurance company (in return for payment of a premium), for the benefit of and at the request of the employer, in a stipulated maximum sum of liability and enforceable by the employer in the event of the contractor's default, repudiation or insolvency (Robinson et al. 1996).

There are two types of performance bond. The distinction between conditional and unconditional 'on demand' guarantee is discussed in the case of *China Airlines Ltd v Maltran Air Corp Sdn Bhd (formerly known as Maltran Air Services Corp Sdn Bhd) and Another Appeal* [1996] 2 MLJ 517 and later is agreed upon in the case of *Government of Malaysia v South East Asia Insurance Bhd* [2000] 3 MLJ 625. In the former case, the court cited that:

A bank guarantee is a performance bond. There are two types of performance bond. The first type is a conditional bond whereby the guarantor becomes liable upon proof of a breach of the terms of the principal contract by the principal and the beneficiary sustaining loss as a result of such breach. The guarantor's liability will therefore arise as a result of the

principal's default. The second type is an unconditional or 'on demand' performance bond which is so drafted that the guarantor will become liable merely when demand is made upon him by the beneficiary with no necessity for the beneficiary to prove any default by the principal in performance of the principal contract.

However, in Malaysia, for the past 20 years and since the famous *Teknik Cekap Sdn Bhd v Public Bank Berhad* [1995] 3 MLJ 449 to the recent *Suharta Development Sdn Bhd v United Overseas Bank (M) Bhd & Anor* [2005] 2 MLJ 762, the question of whether the performance bond in a construction contract is a conditional or an unconditional guarantees is still one of the issues relating to performance bond that been discussed.

In *Suharta Development Sdn Bhd v United Overseas Bank (M) Bhd & Anor* [2005] 2 MLJ 762, Abdul Wahab Said Ahmad JC stated that:

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

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

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

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

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

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

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

Hence it is important and necessary to understand the circumstances in performance bond, which will be available to the parties to a building contract. And from that, the parties involved will clearly defined their rights and liability against bonds and guarantee to assist the respective party in construction contract (Ismail, 2007).

2. LITERATURE REVIEW

The success of a construction project is measured by its timely completion to specification within the budget allocated. However, in the execution of any engineering project there is invariably an element of risk involved (Radhakrishnan, 1999): that is to say, construction is a highly risky business, where the level of risk is considered much higher than in other types of economic activities (Abdul-Rashid, 2004).

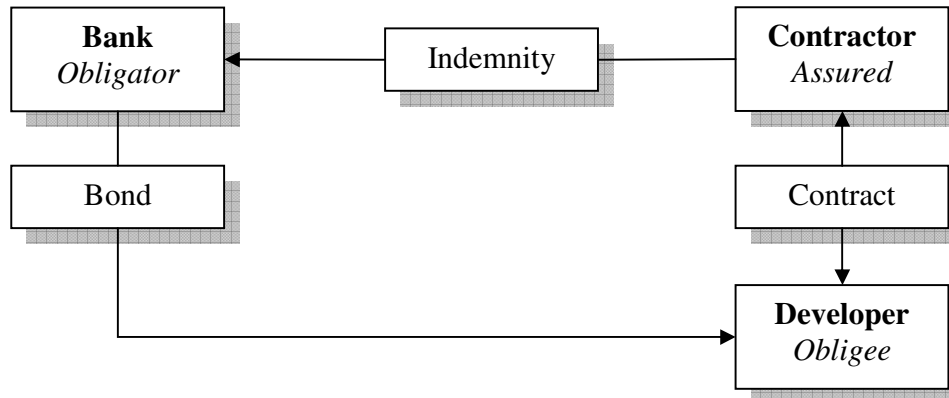
All parties take some form of risk when they enter into construction contract. The acceptance of an obligation brings with it the acceptance of a commensurate risk, i.e. the risk of being unable to fulfill the obligation because one's own inadequacy, incapacity, inadvertence or error, or because of interference from outside sources or supervening events (Robinson et al. 1996).

Risks are inevitable and cannot be eliminated. They can, however, be transferred (Murdoch and Hughes, 2000). One of the main roles of a contract is to distribute risks between the parties. Standard forms of contracts contained express risks distributing provisions. Risk transferring contracts commonly exist between the various parties concerned in construction (Robinson et al. 1996).

In the context of public infrastructure work in Malaysia, one major risk to the Government is non-performance of construction contracts by the contractors (Abdul-Rashid, 2004). Performance bond, however, is a legal and management instrument used by employers to manage risk with respect to contractor's nonperformance.

2.1 Definition

In construction contracts, a 'performance bond' is a bond taken out by the contractor, usually with a bank or insurance company (in return for payment of a premium), for the benefit of and at the request of the employer, in a stipulated maximum sum of liability and enforceable by the employer in the event of the contractor's default, repudiation or insolvency (Robinson et al. 1996). These relationships can be illustrated in Figure 1.



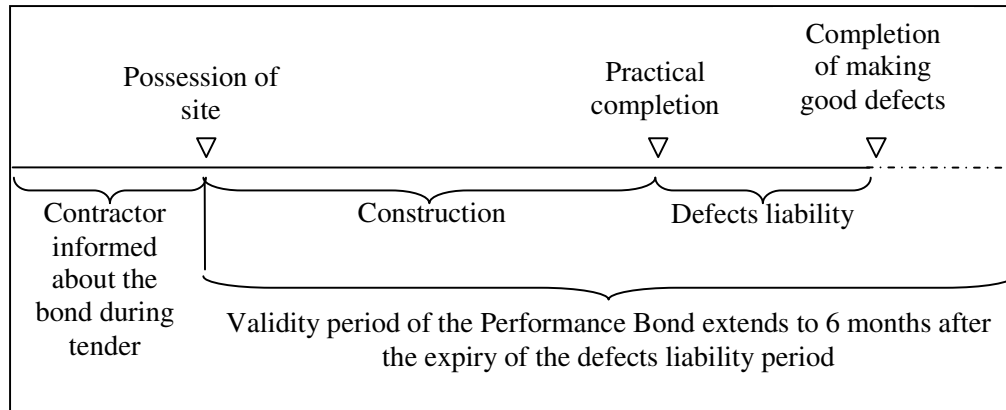
Source: (Fong, 2004a)

Figure 1. Relationships of Parties to a Bond and the Underlying Contract

In Malaysia, most of the need of a performance bond is made through an agreement between the Government, the contractor and a third party (usually a bank or insurance company), whereby the third party agrees to pay a sum of money to the Government, in the event of non-performance of the construction contract by the contractor (Abdul-Rashid, 2004). It is provided in Clause 37(a) of the *P.W.D. Form 203A (Rev. 10/83) Standard Form of Contract to be Used Where Bills of Quantities Form Part of the Contract* that the Contractor shall either deposit with the Government a performance bond in cash or alternatively by way of a Treasury's Deposit or Banker's Draft or approved Banker's or Insurance Guarantee equal to 5% of the Contract Sum as a condition precedent to the commencement of work. In other words, the Contractor is not permitted to carry out any work under the Contract unless and until the performance bond is given. The failure of the Contractor to give the performance bond may amount to a

fundamental breach of contract entitling the Government to discharge the Contract and sue the Contractor for damages accordingly (Fong, 2004b).

The validity period of the performance bond is as indicated in Figure 2 below. By clause 37(b), the performance bond is required to be maintained for such period as provided in the PWD Bond, i.e. until 6 months after the expiry of the Defects Liability Period stated in the Contract calculated from the date of completion of the Works or any authorized extension thereto or if the contract is determined, until one year after the date of determination (Fong, 2004b).



Source: (Abdul-Rashid, 2004)

Figure 2. Time line indicating the validity period of the performance bond

2.2 Purpose of Performance Bond

Rekhraj J in the case of *Lotterworld Engineering & Construction Sdn Bhd v Castle Inn Sdn Bhd & Anor* [1998] 7 MLJ 105 stated that the purpose of performance bond is as follows:

It is to be understood that the purpose of the performance bond in the construction industry is to perform the role of an effective safeguards against non-performance, inadequate performance or delayed performance and its production provides a security as readily available to be realized, when the prescribed event occurs, viz a viz simply failing to complete the work which had been contracted to carry out.

The purpose of a bond is therefore to provide the employer with some financial security in the form of a cash payable by the bank for the contractor's failure to perform his obligation under the construction contract.

2.3 Performance Bond in Construction Contract

Whether or not a contractor is required to provide performance bond depends on the terms of the contract. In Malaysia, as in the above definition, Clause 37(a) of the *P.W.D. Form 203A (Rev. 10/83) Standard Form of Contract to be Used Where Bills of Quantities Form Part of the Contract* states that the Contractor shall either deposit with the Government a performance bond in cash or alternatively by way of a Treasury's Deposit or Banker's Draft or approved Banker's or Insurance Guarantee equal to 5% of the Contract Sum as a condition precedent to the commencement of work. In other words, the Contractor is not permitted to carry out any work under the Contract unless and until the performance bond is given. The failure of the Contractor to give the performance bond may amount to a fundamental breach of contract entitling the Government to discharge the Contract and sue the Contractor for damages accordingly (Fong, 2004b). However, it is not the only places where performance bond is mentioned.

Under Clause 10 of the Conditions of Tendering in the *Form of Tender (PWD 203B Rev. 1/82)* states the following:

The successful tenderer shall so soon as it practicable but before the commencement of the Works deposit with the Superintending Officer Performance Bond amounting to 5% of the Contract Sum;

Another place where the requirement of performance bond is mandatory before commencement of contractor's works is under Clause 4 of the *Letter of Acceptance (PWD 203D – Rev. 1/82)*, which states:

I wish to draw your attention to the Conditions of Tendering whereby as conditions precedent to the commencement of the Works, you are required to deposit with the Government or the Superintending Officer Performance Bond amounting (being 5% of the Contract Sum) in cash or in the form of Treasury's Deposit, Banker's Draft or an approved banker's or Insurance Guarantee.

It is also unusual for private projects to require the contract to provide performance bond. Performance Bond, however, is the precondition for:

- *Taking possession of site*
By Clause 38(a) of the *P.W.D. Form 203A (Rev. 10/83) Standard Form of Contract to be Used Where Bills of Quantities Form Part of the Contract* it is made clear that even if possession of the Site has been given, the Contractor cannot commence work unless and until the performance bond and the insurance policies required under the Contract have been deposited with the Government or the Superintending Officer. Thus if the Contractor delays in depositing the performance bond or insurance, he does so at his own peril as the time available for the execution of the Works under the Contract would be ticking away (Fong, 2004b).
- *Advance payment*
The advance payment is paid to the Contractor upon application from him together with a bank or insurance guarantee for the amount of advance to be paid, and provided that he has returned the Letter of Acceptance duly signed and witnessed, and submitted the Performance Bond and the requisite insurance policies required by the Contract (Jabatan Kerja Raya, 1988).
- *First interim payment*
It is further provided that, other than for the first Interim Certificate, the Superintending Officer need not issue further Interim Certificates unless and until the Contractor has returned to the Government the Letter of Acceptance of Tender duly signed by the Contractor, and has deposited with him or the Government the insurance policies and performance bond required under clauses 33, 34, 36 and 37 of these Conditions in the *P.W.D. Form 203A (Rev. 10/83) Standard Form of Contract to be Used Where Bills of Quantities Form Part of the Contract* respectively (Fong, 2004b).

2.4 Types of Performance Bond

There are two types of performance bonds, as set out below (Robinson et al. 1996):

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

A sample of a conditional performance bond can be found in the case of *Teknik Cekap Sdn Bhd v Public Bank Berhad* [1995] 3 MLJ 449 as follows:

If the sub-contractor (unless relieved from the performance of 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 contractor up to and not exceeding the sum of RM422,000 (Malaysian Ringgit four hundred twenty two thousand) only representing 10% of the contract value or such part thereof on the contractor's demand notwithstanding any contestation or

protest by the sub-contractor or by the guarantor or by any other third party, provided always that the total of all partial demands so made shall not exceed the sum of RM422,000 (Malaysian Ringgit four hundred twenty two thousand) only and that the guarantor's liability to pay the contractor as aforesaid shall correspondingly be reduced proportionate to any partial demand having been made as aforesaid.

On the other hand, a sample of an unconditional on demand performance bond can be found in the case of *Kirames Sdn Bhd v Federal Land Development Authority* [1991] 2 MLJ 198 as follows:

We, Jerneh Insurance Corporation Sdn Bhd Limited, having the registered office at 7th Floor, Wisma MISC, No 2, Jalan Conlay, Kuala Lumpur do hereby irrevocable and absolutely guarantee that the sum of Ringgit 117,535 by way of security deposit under the said contract shall be paid to you by us as per the following terms:

- (a) the said sum of Ringgit 117,535 shall be paid by us forthwith on demand by you in writing without your having to assign any reason whatsoever for such demand;*
- (b) the said sum of Ringgit 117,535 shall be paid by us forthwith to you irrespective of whether or not there is any dispute between the said contract and yourselves (the Authority) in respect of or relating to the said contract or in respect of any other matter and irrespective of whether or not such said dispute, if any, has been settled, resolved, litigated or adjudicated upon otherwise howsoever.*

Thus it is seen in the above samples that the main distinction between the two types of bond is with respect to the requirements for making call on the bond. In conditional performance bond, the beneficiary must comply with conditions precedent for calling the bond. In on demand performance bond, on the other hands, the only condition precedent for calling the bond is a written notice to the guarantor.

2.5 Construction of Performance Bond

In order to determine the construction of a performance bond, Sir Denys Buckley stipulated in the case of *IE Contractors Ltd v Lloyds Bank PLC, and Rafidain Bank* [1990] 2 Lloyd's Rep 496, SI Build LR 1 that:

I am in entire agreement with the proposition that to discover what the parties intended should trigger the indemnity under the bond involves a straightforward exercise of construction, or interpretation, of the bond to discover the intention of the parties in that respect.

3. METHODOLOGY

The main aim of paper is analyzing and commenting the content of the Performance Bond in relation to whether it is a conditional or an unconditional on demand guarantee through the legal point of view from the examples of judgment held in law cases. By using the words 'Performance Bond', 67 cases for the past 20 years were downloaded from the Malayan Law Journal and analyzed further. From the first reading and screening of the above cases, the judge of 25 cases did interpret the distinction between 'conditional' and 'unconditional' Performance Bond. Further screening was done from the 25 cases whereby only cases which the judge discussed on the wordings or phrase(s) of the Performance Bond were further analyzed. This made 15 cases were identified and further consumed. From this, it seems that most of the judges referred to the surrounding five law cases which were discussed below to interpret whether the wording of the performance bonds are conditional or unconditional 'on-demand' bonds.

4. RESULTS AND DISCUSSIONS

The judgment of fifteen law cases had been analysed to differentiate the conditionality of the performance bond by its wordings. Some of the cases held that the performance bonds were conditional performance bond and some of them held the performance bond to be unconditional 'on-demand' performance bond. However, some interesting conclusion can be made from the words in the performance bond.

The first and mostly referred is *Easal (Commodities) Ltd & Reltor Ltd v Oriental Credit Ltd & Wells Fargo Bank NA* [1985] 2 AC 546 which gives the conclusion that there are three possible meanings

for the words used in the performance bond, i.e. no more a written demand is required; the demand must assert a failure to perform the contract; and there must in fact have been a failure to perform. However, most of the judge rejected the last possible meaning of the words used.

In interpreting the words of the performance bond, the second case of *Esso Petroleum Malaysia Inc v Kago Petroleum Sdn Bhd* [1995] 1 MLJ 149 referred the third case of *IE Contractors Ltd v Lloyd's bank plc and Rafidain Bank* [1990] 2 Lloyd's Rep 296, which a conclusion can be made that there was a bias or presumption in favour of the construction that performance bond was to be conditioned upon documents rather than facts.

The fourth case is also the famous Malaysian case of *Teknik Cekap Sdn Bhd v Public Bank Bhd* [1995] 2 Lloyd's Rep 296 which held that because the performance bond because the bond began with the words '*if the subcontractor ... shall in any respect fail to execute the contract or commit any breach of his obligations thereunder then the guarantor shall pay ...*', the bond was a conditional bond.

Last but not least, the case of *Edward Owen Engineering Ltd v Barclays Bank International Ltd* [1978] 1 QB 159 stressed the general nature of a performance bond that a bank is not concerned in the least with the relations between the supplier and the customer nor with the question whether the supplier has performed his contractual obligation or not, nor with the question whether the supplier is in default or not, the only exception being where there is clear evidence both of fraud and of the bank's knowledge of that fraud.

However, Steve Shin J in *Fasda Heights Sdn Bhd v Soon Ee Sing Construction Sdn Bhd & Anor* [1999] 4 MLJ 199 made quite good critics as to the wordings of the performance bond. He said that there are two 'conditions' that the bank must adhere to. The first is that the demand is in writing. It has been said that such a 'condition' is merely to regulate the right to call on the guarantee and is therefore purely a procedural matter. It does not render a guarantee conditional in the true sense. The second is that the contractor fails to execute the works and/or in breach of the contract. Three possible meanings for the words used: (i) that no more than a written demand was required; (ii) that the demand must assert a failure to perform the contract; or (iii) that there must in fact have been a failure to perform. Most of the courts unanimously rejected the third solution.

Kamalanathan Ratnam JC in *Ramal Properties Sdn Bhd v East West-Umi Insurance Sdn Bhd* [1998] 5 MLJ 233 also made quite interesting statements towards the meaning of the words in the performance bond. He said that the wordings of '*If the contractor ... shall in any respect fail to execute the contract or commit any breach of his obligations thereunder, then the guarantor will indemnify and pay the principal ...*' renders the performance bond to be an on-demand performance bond which is only conditional upon the beneficiary asserting the basis of the claim upon the issuer of the bond contending that there has been a breach of contract.

5. CONCLUSIONS

After discussing on the interpretation on application of injunction relief in performance bond, it is noticed that very careful choice of words should be adopted by the constructor of a performance bond so that a clear understanding of its conditionality can be achieved and undisputable. Therefore, the following possible suggestion should be made on the choice of words which could carry the meanings of the performance bond to be conditional or unconditional 'on-demand' bond.

The choice of words should be an undisputed meaning of the words in the performance bond. This should indicate whether the performance bond itself is either purely conditional or purely unconditional 'on-demand' bond. The best examples for this are in the cases of *Esso Petroleum Malaysia Inc v Kago Petroleum Sdn Bhd* [1995] 1 MLJ 149 and *IE Contractors Ltd v Lloyd's bank plc and Rafidain Bank* [1990] 2 Lloyd's Rep 296 which respectively as follows:

“... we hereby unconditionally and irrevocably guarantee the payment to EPMI”

“We undertake to pay you, unconditionally, the said amount on demand, being your claim for damages brought about by the abovenamed principal.”

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