Your Contractual Questions Answered

What Is A Performance Bond, Its Purposes And Implications?

By the Entrusty Group

The Entrusty Group, a multi-disciplinary group of companies, of which, one of their specialisations is in project, commercial and contractual management, has been running a regular contractual question-and-answer section for MBAM members in Master Builders Journal.

In this instalment of the series, the Entrusty Group will provide the answer to the frequently asked question above.

Bonds are provided as useful means of creating financial security for the Employer for the Contractor's failure to perform his contractual obligations.

Generally, a bond is an arrangement under which the performance of one party (A) to another party (B) is backed up by a third party (C). What happens is that C promises to pay B a sum of money if A fails to fulfil the relevant duties. In this context A is commonly known as the principal debtor or simply principal; B is called the beneficiary; and C is called the bondsman, surety or guarantor.

In the construction context, such back-up is likely to come from one of the two sources below:

(a) Parent Company Guarantee – the contractual performance of one company within a corporate group is underwritten by other members of the group; or

(b) Bonds – normally provided (at a price) by a financial institution such as a bank or an insurance company.

The obligations most commonly guaranteed by bonds or guarantees are as follows:

- **Payment:** For example, the Employer's duty to pay the Contractor or the Contractor's duty to pay a Sub-Contractor. A Contractor may also provide a bond in favour of the Employer, in return for an early release of retention money or, indeed, completely replacing the retention provisions. If defects are then found in the building, the Employer can call on the bond, rather than the retention money, to finance the necessary remedial work.
- **Specific Obligations:** Such as a promise by a Sub-Contractor not to withdraw a tender. This may be of practical importance where, say, a main Contractor tenders on the basis of bids received from domestic sub-contractors. If the main Contractor, having been awarded the job, finds that a Sub-Contractor's bid is no longer open for acceptance, the main Contractor may then have to pay a significantly higher price to another sub-contractor for that part of the work.
- **Performance of the contract in general:** This is the most common type of bond, in which every aspect of the Contractor's performance is guaranteed. The contract frequently requires a bond, normally to a level up to 10% of the contract sum.

The usual form of bond used in Malaysia is a Performance Bond which guarantees the Contractor's performance of the contract with an undertaking to be bound in a specified sum until (and unless) such performance is achieved. Upon the Contractor's failure to perform in full, the Employer is entitled to call on the surety (or bondholder) to make good the loss, up to the maximum amount of the bond.

Since a bond is a contract of guarantee, it requires to be evidenced in writing. Further, since the Employer gives no consideration (save that the Contractor must include the cost of the bond in his price for the works) the bond must be made by deed.

The construction contract and the bond are inter-related, since the bond is a tripartite transaction involving the parties to the construction contract and the bond. Nonetheless the bond is a separate and wholly independent legal document enjoying autonomy from the construction contract. In that sense the bond is independent of the construction contract.

Performance bonds are traditionally categorized as being of two types. The first type is the **'conditional'** bond, where the surety agrees to pay if and when certain specified conditions are satisfied. The most likely condition would be any default (i.e. breach of contract) by the Contractor. The principal characteristics of this type of bond are namely:

- It is a contract of guarantee whereby the surety (guarantor, i.e. the Bank) accepts 'joint and several' responsibility for the performance of the Contractor's obligations under the engineering and construction contract (i.e. the principal contract); and
- The surety only becomes liable upon the operation of the 'trigger clause', i.e. proof of a default/breach of the terms of the principal contract, and the Employer (beneficiary) sustaining loss as a result of such default/breach.

The second type of bond is the **'unconditional'** bond which entitles the beneficiary to call upon the surety for payment whether or not there has been default under the principal contract, provided only that the call is not fraudulent. These bonds exhibit the following characteristics:

- It is a pledge by the surety (guarantor, i.e. the Bank) to indemnify the beneficiary (i.e. the Employer) merely when demand is made upon him by the latter;

- It entitles the beneficiary to call upon the surety for payment whether or not there has been default under the principal contract provided only that the call is not fraudulent – **LEC Contractors (M) Sdn Bhd** v **Castle Inn Sdn Bhd & Anor (2000) 2 MLJ 339**.

The duration of a guarantee depends upon the terms in which it is given. If no specific time limit is mentioned, then a surety for the Contractor's performance is not released by completion or even by the final certificate but remains liable, as does the Contractor, for any breach of contract which comes to light within the relevant limitation period.

Generally, as a rule, a performance bond remains in force until the stated discharge date which is usually either after practical completion of the works or after making good any defects. However, should the practical completion or making good of defects occur earlier than the bond date, the bond cannot be recalled or withdrawn unless the client agrees to an earlier release date. Furthermore, a performance bond is not an insurance policy which normally is a contract of indemnity under which the insured is indemnified in the event of loss, subject to the adequacy of the sum insured. Moreover, there are three parties under a performance bond (i.e. the Contractor, the client and the surety company) as opposed to two under an insurance policy (i.e. the insurer and the insured). Once a bond is issued, it cannot be cancelled until the stated discharge date or until the subject matter of the indemnity has been completed satisfactorily, however, an insurance policy can be cancelled before its expiry date.

The financial limits of liability are invariably expressed in the contract of guarantee. It should be made clear, in order to avoid disputes, whether interest on money due, and legal costs, are included in the overall limit. It is also worth noting that some bonds provide for the entire sum guaranteed to become payable on any breach by the principal, regardless of how serious or trivial that may be. If this is the case, the provision is likely to be struck down as a 'penalty' and the beneficiary will be entitled only to so much of the sum as will compensate for the actual loss which has been suffered.

There has been considerable confusion as to what the principles are for bonds, but the fairly recent decision of **IE Contractors Ltd** v **Lloyds Bank plc and Rafidain Bank (1991 51 Build LR 1)** has cleared the air by stating that the correct approach, is not to categorize performance bonds as being 'on demand' or 'unconditional' – as seems to have been the past practice – but simply to treat them as contracts and to interpret each document as such.

Much of the difficulty which the courts have faced when dealing with performance bonds can be traced to the earlier decisions of the English Court of Appeal in **Edward Owen Engineering Ltd** v **Barclays Bank International Ltd (1978) QB 159**. It was held that a guarantee or bond payable on demand without proof or conditions imposes an obligation on the guarantor to pay. This is irrespective of whether or not the person whose performance was guaranteed has in fact performed his obligations or was in default. The only exception is in cases of fraud of which the guarantor had notice.

The distinction between a bond (an on-demand bond) and a guarantee (a conditional on-default bond) is important, but not always easy to make.

In **IE Contractors Ltd** v **Lloyds Bank PLC (1990)**, it was held that although in the case of letters of credit the documents presented must be precisely those called for, there was less need for such a doctrine in the case of the performance bonds. Performance bonds are, after all, merely collateral contracts and they should be treated and construed as contracts. Thus, the difference between letters of credit and performance bond was a matter of construction of the bond.

In **Esal** v **Oriental Credit (1985) 2 Lloyd's Rep 546 at 549**, the bank undertook to pay '*on your written demand in the event that the [Contractor] fails to execute the contract in perfect performance*'.

This looked like a conditional bond but it was interpreted by the England's Court of Appeal as unconditional because the initiating event was the demand and that it could not have been intended that the bank would be concerned with the assessment of whether or not there had been perfect performance.

In **Perar BV** v **General Surety and Guarantee Co Ltd (1994) CA 66 BLR 77**, the England's Court of Appeal held that there is no obligation to continue with the work once there had been an automatic termination when the Contractor went into administrative receivership. Since 'default' meant simply 'breach of contract', the Contractor's insolvency did not constitute default. In effect, therefore, the bond provided no protection in precisely the circumstances where it was needed in cases of insolvency.

The UK's House of Lords considered the question whether the bond which was in the form of a guarantee would allow the surety to take into account unpaid sums due for work done and cross claims for set off in **Trafalgar House Construction** v **General Surety Guarantee Company (1994) 66 BLR 42.** It was held that the bond itself contained indications that it was intended to be a guarantee. So, the description 'the surety' was used. Also there was provision that alteration of the terms of the construction contract would not release the surety from liability. This pointed to the bond being a guarantee. In addition there was relevant authority in decided cases which supported the view that the bond was a guarantee. The terms of the bonds in these cases could not be distinguished from the terms of the bond in the instant case.

The UK's House of Lords also considered that the particular words *'damages sustained by the Contractor thereby'* were sufficient to limit the liability of the surety. It was held that in order to do so the words used must be clear and unambiguous.

In **Cargill International SA** v **Bangladesh Sugar & Foods Corp (1996) 4 All ER 563**, it was held that money must be paid without question under a performance bond to a party although he has suffered no damage. The rights and wrongs will be argued later, subject to terms under the bond to the contrary. A term was to be implied in the contract that moneys paid under the bond which exceeded the buyer's actual loss would be recoverable by the seller.

Any term of the contract which enabled the buyer to call on the bond when he had suffered no damage, and retain the moneys, would be held to be a penalty from which the court would give relief by ordering repayment of the sums paid.

In **Themehelp Ltd** v **West and Others (1995) CA All ER 1995 Vol 4**, it was held that where fraud is raised between the parties to the Main Contract, it is not a threat to the autonomy of the performance guarantee if an injunction is granted before the question of enforcement of the guarantee between the guarantor and beneficiary has arisen. The Court has jurisdiction to grant the injunction but did not consider whether this principle extended beyond instances of fraud, to cases where the beneficiary is alleged to be in non-fraudulent breach of the Main Contract.

It was held in **Oval (717) Limited** v **Aegon Insurance Company (UK) Limited June 1997** that the bond was a contract of guarantee albeit in archaic language, relying on **Perar BV** v **General Surety and Guarantee Co Ltd (1994) 66 BLR 72**. It was held that the Plaintiff was required to notify the Defendant of those defaults which were appreciated by the Plaintiff at the time in relation to the contractual obligations extant at that time. He was required to notify no more to the Defendant than he notified to the Contractor subject to the event being self evidently insubstantial, or of obvious insignificance. It is left to the Defendant to assess for itself the actual or potential significance of the information received.

It was held that as the Plaintiff had failed to give the Defendant the required written notice of the Contractor's failure to complete the works by the duly extended completion date, the Plaintiff was not entitled to make a call and recover under the bond since the Defendant has raised the issue of non-compliance with the condition precedent.

The Malaysian Approach

Performance bonds are, essentially contracts of guarantee and so fall within the purview of the Contracts Act 1950, Sections 79 to 81.

The case of **Syarikat Perumahan Pegawai Kerajaan Sdn Bhd V Bank Bumiputra Malaysia Bhd (1990) 1 CLJ 159** shows the approach of the Malaysian courts to the troublesome problems thrown up in this area. Lim Beng Choon J had to consider the effect of Section 81 of the Contracts Act 1950 on a bank's obligation to pay on a performance bond or guarantee given to support the performance of a building contract.

In any event, it was necessary to discern the case law of **Edward Owen** in light of the provisions of Section 81 of the Contracts Act, and especially the closing phrase *'unless it is otherwise provided by the contract'.*

In **Syarikat Perumahan**, it was not clear from the face of the document that the bank was absolutely bound to pay 'on demand'. It is considered that a different **construction** was tenable and that the document was not plainly of an 'on demand' type. Lim Beng Choon J certainly seems to have been heavily influenced by the views espoused by Lord Denning and some of his colleagues in earlier English cases which equated bonds with letters of credit. This is now a discredited view in light of the recent restatement and clarification of the applicable principles by the English Court of Appeal in **IE Contractors**.

Although the wording of the document in **Syarikat Perumahan Pegawai Kerajaan Sdn** v **Bank Bumiputra Malaysia Bhd** was plainly based on the current Public Works Department form of bond, there are material differences between the wording of the two documents.

The material part of the PWD Bond reads:

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 Government up to and not exceeding [$x] ***on the Government's demand notwithstanding any contestation or protest by the Contractor or by the Guarantor or by any third party.*** (Emphasis added.)

This is plainly intended to operate as an 'on demand' bond; the same cannot be said of the document in **Syarikat Perumahan**. The words which are emphasized in the quotation did not appear in the bond used in **Syarikat Perumahan**, and it is respectfully submitted that the case should not be regarded as laying down any general principle at all. Where English case law is to be cited locally, **IE Contractors Ltd** v **Lloyds Bank plc** should now provide the starting point. Lord Denning's view that performance bonds stand on a similar footing to letters of credit - with the inevitable arising consequences - should be relegated to the home of lost causes.

As a conclusion, bonds are to be treated as collateral contracts and each document is to be interpreted on an individual basis. MBJ

The next issue will be providing the answer to the question, **What is the recent position on retention sums in Malaysia?**