

Construction Performance Guarantee: Performance Bond

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ABSTRACT

Nowadays in the construction industry, the problems of non-performance by the contractor have become a common thing faced by the client. This problems usually happens the contractor failed to execute the according the contract. It has been a common issue in Malaysia when dealing with contractor's non-performance. Thus the client needs a protection in the event when the Contractor fails or defaults in its performance under the contract, such as abandonment or the works is of proof or any defects in the work appearing during the defects liability period. Contractor's performance guarantee is the feature or a management tool to handle the risk of non-performance by the contractor. Performance bond are introduced to ensure that contractor will honour and perform the contractor diligently. If the contractor failed to execute the work within the specification of the contract or the contractor abandoned the work, the performance bond can be used towards the disbursement of expenses incurred by the employer in rectifying the defect. Performance bond is three party agreement between the employer, contractor and a third party (usually a bank or insurance company), who agrees to pay sum of money to the employer, the event of default by the contractor in the construction contract. If the contractor has performed in the contract or in the words, has carried out the work within the contract, the client needs to release back the performance bond.

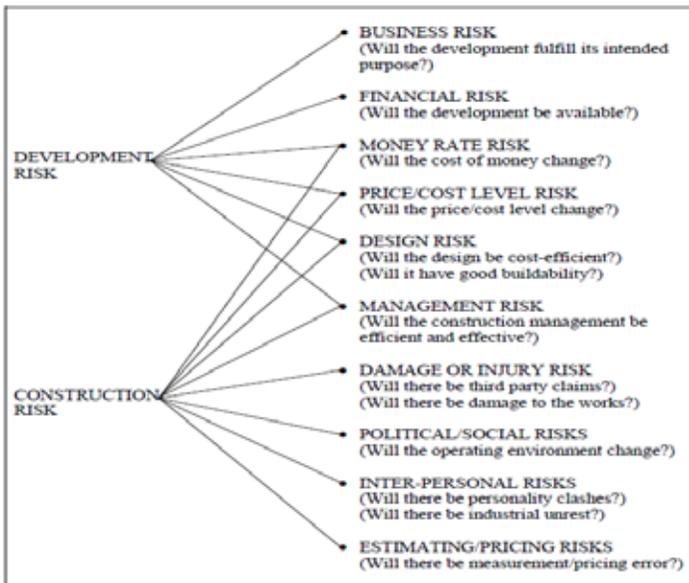
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INTRODUCTION

In the context of construction industry, many of us would acknowledge that the success of a construction projects are often attributed to those that able to meet the client’s requirement and project objectives that has been determined during the initial stage of the project. Such objectives are completion on time, construct within the budget allocated, and achieve require and standard of quality. Other objectives may include meeting functional requirements of the clients and/or end users. Notwithstanding such as requirements and objectives, the construction industries still suffer from numerous setback and problem (Ong Hock Teng, 2007). It also involved invariably list: (Radhakrihnan,1999) that is to say that the construction industry is a highly risky business, where level of risk is considered much higher than in other types of economic activities (Rashid, 2004). Figure 1.1 shows that the risk spectrum which identifies some principle sources of risk. Furthermore, projects involve commercial risks and they involve people (Murdoch & Hughes, 2000).



Source: (Robinson et. al.,1996)

Figure 1: The Risk Spectrum: Some Principle Sources of Risk

There are many types of risk in construction contract. Usually risk that involves in the construction contracts are risk that cannot begin avoided. The following examples summarize many of the risks. Some of them are contractor's risks (for example: workmanship, materials, etc.) (Murdoch & Hughes, 2000).

1. Physical works – ground conditions; artificial obstructions; defective materials or workmanship; tests and samples; weather; site preparation; inadequacy of staff, labour, plant, materials, time or finance.
2. Delay and disputes – possession of site; late supply of information; inefficient execution of work; delay outside both parties' control; layout disputes.
3. Direction and supervision – greed; incompetence; inefficiency unreasonableness; partiality; poor communication; mistakes in documents; defective designs; compliance with requirements; unclear requirements; inappropriate consultants or contractors; changes in requirements.
4. Damage and injury to persons and property – negligence or breach of warranty; uninsurable matters; accidents; uninsurable risks; consequential losses; exclusions, gaps and time limits in insurance cover.
5. External factors – government policy on taxes, labour, safety or other laws; planning approvals; financial constraints; energy or pay restraints; cost of war or civil commotion; malicious damage; intimidation; industrial disputes.
6. Payment – delay in settling claims and certifying; delay in payment; legal limits on recovery of interest; insolvency; funding constraints; shortcomings in the measure and value process; exchange rates; inflation.
7. Law and arbitration – delay in resolving disputes; injustice; uncertainty due to lack of records or ambiguity of contract; cost of obtaining decision; enforcing decisions; changes in statutes; new interpretations of common law.

In the context, the public infrastructure work in Malaysia, one major risk to the Government is non-performance of construction contracts by the contractors. Performance bond is illegal and management instrument used by the employers to manage risk with respect to contractor's non-performance.

LITERATURE REVIEW

Definition

Performance bond is a bond giving security for 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 the context of construction contracts, the contractor commonly required to furnish performance bond for due performance of the work. Performance bond usually takes the form of an 'on-demand' and irrevocable banker's guarantee. The value of performance bond typically required by employers in Malaysia is 5% to 10% of the contract price (Pathmavathy and Nayagam, Skrine & Co., 2007).

Nature of Performance Bond

A bond or guarantee is an arrangement under which the performance of a contractual duty owed by one person (A) to another (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 duty. 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 (Murdoch & Hughes, 2000).

In a construction contract, performance bond is also a three-party instrument between bondsman, the employer and the contractor. The agreement, however, binds the contractor to comply with the terms of a contract. If the contractor fails to perform the contract, the bondsman assumes the responsibility to indemnify the employer up to the maximum amount of the bond. The Bondsman's obligation to pay is now arises when called upon to do so by the employer.

The obligation to pay is, however, independent of the underlying contract. This is due to the fact that the performance bond is like a letter of credit and designed to release ‘no quibble’ cash to the beneficiary in the event the call on the bond.

Purpose of Performance Bond

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.

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 Clause 38(i) of the *P.W.D. Form203A (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 (Lim Chong Fong, 2004). 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 (PWD203B 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...”

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

1. *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 (Lim Chong Fong, 2004).

2. *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 (JKR, 1998)

3. *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* (Lim Chong Fong, 2004).

Types of Performance Bond

There are two types of performance bond: conditional and unconditional or on demand. Mohamed Dzaiddin FCJ in delivering the grounds of judgment of the court in *China Airlines Ltd v Maltran Air Corp Sdn Bhd (formerly known as Maltran Air Services Corp Sdn Bhd) and Another Appeal* [1996] 37 (Malayan Law Journal, 1996) reveal this by saying:

“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.”

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

1. *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.
2. *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.

Construction of Performance Bond

To ensure the contractor furnishes the performance bond to the employer:

1. The contract may stipulate the provision of performance bond as a condition precedent to commencement of works and payments by the employer
2. The contract may entitle the employer to terminate the contractor's engagement in the event the contractor fails to furnish the performance bond within requisite period.

The contractor may entitle the employer to withhold monies which may become due to the contractor under the contract in the event the contractor fails to furnish the requisite performance bond (Pathmavathy et. al., 2007).

METHODOLOGY

Performance bond has been one of the causes of many disputes between client and contractor. The common problem has always been whether performance bond in the construction contract is a conditional or unconditional bond. In this case studies, various issues that arise affecting the performance bond is highlighted and discussed. After knowing the issues faced by the parties involved in the event of performance bond, the analysis on legal position for each issue is determined so that the parties involved has knowledge about the legal issue arise.

RESULTS AND DISCUSSIONS

By using the words 'Performance Bond', 67 cases for the past 20 years were downloaded from the Malayan Law Journal to be analysed 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 will be further analysed. From this, 15 cases were

identified to be further consumed as follows and 1 case to be detailed out for each unconditional and conditional performance bond:

1. Law Cases No 1

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

*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... 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 Air Corp 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 there under 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. In our view the court in the case of **Teknik Cekap** decided it on its own facts. Apparently one of the factors that influenced the court and the court below was the fact that the demand made was band in law. This is our view distinguished that case from the present appeal.*

The judge followed *LEC Contractors (M) Sdn Bhd* and hold this guarantee is an unconditional on demand guarantee.

2. Law Cases No 2

In *Teknik Cekap Sdn Bhd v Public Bank Bhd* [1995]66, Shaik Daud JCA stated that:

It is, therefore, pertinent to set out the relevant clause of the bond which has caused this concern in this case. It can be found on the first page of the bond dated 1 June 1992 issued by PBB and is 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.

*It involves a straightforward exercise of construction, or interpretation, of the bond to discover the intention of the parties'. This is the unanimous view expressed in **IE Contractors Ltd v Lloyds Bank plc and Rafidain Bank** (1990) 51 BLR 1.*

*Much of the confusion and problems in interpreting performance bonds arose with the celebrated decision of the English Court of Appeal in **Edward Owen Engineering Ltd v Barclays Bank International Ltd & Anor** [1978] 1 All ER976; [1977] 3 WLR 764 . In that case, Lord Denning MR having pointed out that performance bond was similar to a letter of credit added that performance bonds are virtually promissory notes payable on demand. Since then it has been seen that performance bonds are, however, not on the same footing as*

letters of credit, they do not form part of the financial transactions supporting the performance of a contract. They are in fact collateral and subsidiary to a contract. In **IE Contractors Ltd v Lloyds Bank plc and Rafidain Bank**, the court made a distinction between letters of credit and performance bonds and made it clear that the question of what was required to comply with a particular performance bond was one of construction of that bond. There is no doubt that some performance bond must be paid merely on a demand being made, and whether this is so must depend on the wording of the bond itself. In **Kirames Sdn Bhd v Federal Land Development Authority** [1991] 2 MLJ 198, the guarantee provided that the guarantor shall **‘irrevocally and absolutely guarantee payment on demand without having to assign any reason whatsoever for such demand’**. In the light of these clear and unambiguous wording it can be said that this is an unconditional and a pure ‘on demand’ bond. What is required to trigger payment in such bonds is the demand simpliciter. In **Esso Petroleum Malaysia Inc v Kago Petroleum Sdn Bhd** [1995] 1 MLJ 149, the then Supreme Court on examination of the performance bond in that case held that it was a pure on demand guarantee and therefore a mere demand would trigger off the guarantees without asserting any reasons thereto. In that case the guarantor agreed to **‘unconditionally and irrevocably guarantee payment ...’**.

In the present case, however, 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 ...’** (emphasis added). Now from the very wording of the bond itself it is clear and unequivocal that what would trigger off the guarantee is the sub-contractor’s failure to execute the contract or commit any breach thereof. Then and only then would the liability of the guarantor arise. Therefore giving the words in the bond their plain meaning, it cannot by any stretch of imagination be said that the bond in the circumstances of this case is an unconditional bond. Similarly in **Esal (Commodities) and Relton v Oriental Credit and Wells Fargo Bank NA** [1985] 2 Lloyd’s Rep 546, the performance bond stated **‘we undertake to pay the said amount on your written demand in the event that the supplier fails to execute the contract in perfect performance ...’** (emphasis added) the Court of Appeal held that:

... however in addition to the beneficiary making the demand he must also inform the bank that he did so on the basis provided for in the performance bond

*The court there found that when making the demands the beneficiary did not assert that there was a failure to perform the contract. The court came to the conclusion that liability under the performance bond was conditional and the condition had not been complied with. The court went on to say that this interpretation not only gave meaning but also effect to the words **‘in the event that the supplier fails ...’** which otherwise would be mere surplusage. This decision was followed by the Court of Appeal in **IE Contractors**. In that case the performance bond stated as follows:*

We undertake to pay you, unconditionally, the said amount on demand, being your claim for damages brought about by the above-named principal. (Emphasis added.)...

Clause 1 of the performance bond stipulates what those conditions are and that clause is worded in the following manner:

If the sub-contractor (unless relieved from the performance of any clause of the contract ...) shall in any respect fail to execute the contract or commit any breach of his obligations thereunder then the guarantor [i.e. the bank] shall pay to the contractor [i.e. Teknik] 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 ...

Teknik interprets that clause to be just this - that the performance bond is an on demand performance bond and the liability to pay arises once a demand is made and the fact that the demand in this case is silent as to any wrongdoing or omission committed by the sub-contractor is immaterial to the validity of the demand as the issuance of the demand itself implies that a breach had already been committed by the sub-contractor...

*In Esal's case, the form of undertaking was expressed as follows: **We undertake to pay the said amount on your written demand in the event that the supplier fails to execute the contract in perfect performance.** (Emphasis added.)*

*Ackner LJ, who delivered the principal judgment, had this to say about the undertaking: ... in addition to the beneficiary making the demand, he must also inform the bank that he does so on the basis provided in the performance bond itself. This interpretation not only gives meaning and effect to the words '**in the event that the supplier fails ...**' which otherwise would be mere surplusage, but it in no way imposes an extravagant demand upon the bank.*

*Our attention was also drawn to the case of **Esso Petroleum Malaysia Inc v Kago Petroleum Sdn Bhd** [1995] 1 MLJ 149, where the Supreme Court in interpreting a performance bond that was before it, held:... [it] was ... a pure on demand guarantee, and all that was required to trigger it was a demand in writing. It would not be dependent or conditional on the production of a document, e.g. a certificate from some nominated independent person like an architect as in some building contracts, etc. Neither was it worded to make it conditional for Bank Bumiputra, the issuer of the performance bond, to inquire into the existence or otherwise of any breach of any contractual obligation between the beneficiary of the bond, i.e. the buyer in this case and the seller; at the behest of the latter itself, the performance bond was issued.*

*The undertaking to pay in **Esso Petroleum's** case simply reads as follows, '**... we hereby unconditionally and irrevocably guarantee the payment to EPMI**' and the mode of making a claim under such a guarantee was worded as follows: **All claims, if any, in respect of or under this guarantee must be made in writing and received by us at any time on or before the expiry of this guarantee.***

*From the Law Case No 1, In **Suharta Development Sdn Bhd v United Overseas Bank (M) Bhd & Anor** [2005] the judge by referring to the **LEC Contractors (M) Sdn Bhd** and hold this guarantee is an unconditional on demand guarantee.*

And for the Law Case No 2 is also the famous Malaysian case of *Teknik Cekap Sdn Bhd v Public Bank Bhd [1995]*. This case held that a performance bond was a conditional 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 ...’***. However, this is the only Malaysian case that the court held the performance bond to be a conditional bond when similar wordings had been used in other Malaysian performance bond.

The held of the above law cases had been cited 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.

*Teknik Cekap Sdn Bhd v Public Bank Bhd [1995]*⁸⁰ 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.

In *Suharta Development Sdn Bhd v United Overseas Bank (M) Bhd & Anor [2005]*, the judge basically using **Esso Petroleum Malaysia Inc v Kago Petroleum Sdn Bhd** to give his judgment that from the wordings of the guarantee it is clear to us that it is ‘on demand’ performance bond. The judge followed **LEC Contractors (M) Sdn Bhd** and hold this guarantee is an unconditional on demand guarantee.

CONCLUSION

After discussing on the interpretation on application of injunction relief in performance bond, it is noted 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. The choice of words again 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.

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