

SINGAPORE COURT EXAMINES CALLS ON ON-DEMAND PERFORMANCE BONDS FOR CONSTRUCTION PROJECTS

On-demand performance bonds (also known as unconditional or demand bonds) are tools commonly used in construction projects to provide the beneficiary with a form of security which is promptly realizable upon a party's non-performance of its obligations.

Singapore law recognises two exceptions to a party's ability to call on such performance bonds: fraud and unconscionability. The latter, seemingly easier to prove than fraud and applicable to a wider variety of factual circumstances, is often raised by applicants seeking to injunct calls on on-demand bonds.

In two recent judgments, the Singapore High Court affirmed the high threshold for establishing unconscionability and provided further clarity on the scope of the exception.

HYFLUX CALL ON BOND UPHeld DESPITE ONGOING RESTRUCTURING GIVEN NO STRONG *PRIMA FACIE* CASE OF UNCONSCIONABILITY

In *Sulzer Pumps Spain, SA v Hyflux Membrane Manufacturing (S) Pte Ltd* [2020] SGHC 122, the Court discharged an *ex parte* injunction obtained by Sulzer restraining Hyflux from calling on an unconditional first demand bond.

Hyflux had engaged Sulzer as its sub-contractor to supply and install pumps for a desalination plant in Oman. Sulzer provided the bond to Hyflux as security for its warranty obligations. Between November 2017 and May 2019, the pumps repeatedly failed. According to Hyflux, the recurring failures were caused by design flaws and Sulzer was therefore in breach of its warranty obligations, which entitled Hyflux to call on the bond. Sulzer then obtained an *ex parte* injunction to prevent the call.

At the *inter partes* hearing, Sulzer argued that the injunction should be maintained as Hyflux's call on the bond was unconscionable. The High Court rejected Sulzer's argument and discharged the injunction.

Key issues

- Two Singapore cases have further illustrated the scope of the unconscionability exception to resist calls on on-demand performance bonds.
- Calling on the performance bond where there is a genuine dispute as to the root cause analysis does not amount to unconscionability.
- Parties calling on performance bonds are not to be treated differently merely because they are undergoing restructuring or even on the verge of insolvency.
- A beneficiary cannot expect to rely on an illegality when calling on a performance bond.

First, the Court affirmed the high threshold for establishing unconscionability, which requires the applicant to show a strong *prima facie* case of unconscionability.

Second, the Court affirmed that calling on the bond where there is a genuine dispute as to the root cause analysis does not amount to unconscionability. Sulzer denied the existence of the alleged design flaws and argued that the failures were caused by Hyflux's misuse of the pumps. The Court agreed with Hyflux that it is not necessary for the Court to go into the merits of the dispute. The evidence and arguments raised by Hyflux sufficiently demonstrated a genuine dispute between the parties. Accordingly, Hyflux's call was not unconscionable.

Third, the Court acknowledged that delay in calling on a bond may, in certain circumstances, show unconscionability. However, this was not the case here even though Hyflux had made the call more than six months after the pumps had been fixed, and nearly two years after the pump failures first arose. The Court noted that a long-drawn dispute may require a longer time for the beneficiary to monitor the situation and decide whether to call on the bond, the nature of the dispute and the depth of disagreement may also be material factors and, further, the fact that the call was made just prior to the bond's expiry does not *ipso facto* indicate any untoward conduct.

Fourth, the Court did not consider the fact that Hyflux was undergoing restructuring proceedings to be relevant to the analysis on unconscionability. The exposure of the obligor to the financial constraints of the beneficiary is not good enough reason to bar a call, since that is part and parcel of the contractual arrangement that the parties have made between themselves in arranging for the performance bond.

CALL ON BOND BARRED WHERE DEVELOPER ACTED UNCONSCIONABLY BY PUSHING CONTRACTOR TO PROCEED WITH ILLEGAL WORKS

In *CEX v CEY* [2020] SGHC 100, the Court granted an injunction to restrain the developer, CEY, from calling on an on-demand performance bond provided by the contractor, CEX, on grounds of unconscionability.

Here, the construction project was beset with delays. CEY claimed that the delays were attributable to CEX's persistent failure to carry out the contract with due diligence and expedition. CEX argued that many of the delays were beyond its control and pointed to, among other things, the hospitalization and subsequent death of the architectural qualified person for the project. When CEY sought to recover losses arising from CEX's alleged breaches of contract and CEX refused to pay, CEY called on the performance bond.

The Court undertook a survey of the cases where a bond has been restrained on grounds of unconscionability, and found that unconscionability has manifested in the following non-exhaustive forms:

- (a) calls for excessive sums;
- (b) calls based on contractual breaches that the beneficiary of the call itself is responsible for;
- (c) calls tainted by unclean hands, e.g., supported by inflated estimates of damages or mounted on the back of selective and incomplete disclosures;

- (d) calls made for ulterior motives; and
- (e) calls based on a position which is inconsistent with the stance that the beneficiary took prior to calling on the performance bond.

The Court found that CEY's call on the bond was unconscionable on the following grounds:

First, CEY was responsible for at least part of the delays (see (b) above). Under the relevant statute, the developer was required to appoint a replacement qualified person. It would have been illegal for CEX to continue with building works in the interim period without supervision from a replacement qualified person.

Second, and more importantly, a beneficiary simply cannot rely on an illegality when calling on a performance bond. The evidence showed clearly that CEY had relied on CEX's failure to continue works during the interim period (which would have been illegal), in terminating CEX's employment and calling on the bond. Therefore, the bond call was rooted in illegality.

ANALYSIS AND COMMENT

The Singapore courts have allowed the exception of unconscionability to cater for situations where the conduct of the beneficiary was sufficiently reprehensible to justify an injunction, but did not amount to fraud. This exception has deterred, to a significant extent, the kind of capricious calls on the bonds which are encountered in other jurisdictions, thereby managing the risk exposure of contractors from on-demand bonds and maintaining their prevalence in the construction industry.

However, the unconscionability exception cannot be allowed to undermine the commercial role that performance bonds are intended to perform – to provide a security that is to be readily, promptly and assuredly realizable when the prescribed event occurs. It is reassuring that both judgments have maintained the high threshold for establishing unconscionability and, importantly, affirmed the presence of a dispute will not suffice in restraining a call on a bond. It is also laudable that the Court has clarified in *Hyflux* that the restructuring or impending insolvency of a beneficiary is not grounds for restraining a call.

One additional takeaway for beneficiaries of performance bonds is that they should be mindful of relying on any illegality in their calls.

In *CEX*, the Court granted a full (as opposed to partial) restraint on the call, notwithstanding that the developer had called on the performance bond to recover its losses arising from multiple delays, only one of which was partly attributable to the developer and related to the illegality. It is unclear if the developer had argued that only a partial restraint ought to be imposed or whether the Court had considered that the illegality tainted the entire call and so warranted a full restraint.

Further, even though the courts have allowed parties to contract out of the unconscionability exception (*CKR Contract Services Pte Ltd v Asplenium Land Pte Ltd* [2015] SGCA 2), it still remains to be tested whether such agreement would extend to situations where the unconscionability arises from illegality given the additional public policy considerations that would be engaged.

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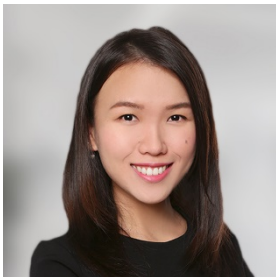
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