Performance Bonds and Unconscionability – the same old chestnut?

Performance bonds are a key feature on construction projects, typically providing the beneficiary with security payable unconditionally on-demand.

The development in Singapore of the doctrine of unconscionability as a separate ground in addition to fraud for restraining calls on on-demand bonds (and similar instruments such as letters of credit) has excited legal commentators since it first emerged in the early 90s.

Countless articles, presentations and papers have explored the development of a doctrine where the Singapore Courts have chosen their own path, (largely) distinct from the English and other commonwealth courts.

The Singapore High Court's recent decision in *Tactic Engineering Pte Ltd (in liquidation) v Sato Kogyo (S) Pte Ltd* [2017] SGHC is not a game changer, but provides some very helpful insight as to the Court's application of the key principles.

In particular, it provides guidance on the archetypal scenario where the beneficiary of an on-demand performance bond (say a contractor) has claims against the party who was obliged to put the bond in place (say a subcontractor). The subcontractor refuses to pay and the contractor considers calling the bond in respect of the sums claimed.

However, in doing so, how strong and how well developed does that claim need to be in order to ensure that the bond call is not considered unconscionable?

Background

Sato Kogyo was engaged by the Singapore Land Transport Authority as main contractor to construct a new MRT Station and associated tunnels as part of the Downtown Line 3. Tactic Engineering was engaged by Sato Kogyo as subcontractor.

Tactic began to suffer financial difficulties and, in turn, faced difficulties in completing its outstanding works.

To ease Tactic's cash flow, Sato Kogyo agreed to release retention monies early in exchange for an on-demand bond of the same value (approximately $1.2 million).

The bond provided that the issuer *"irrevocably and unconditionally agree to pay the same to you immediately on demand without further reference to the Subcontractor and notwithstanding any dispute or difference which may have arisen under the subcontract..."* In other words, it was a true, on-demand bond.

Sato Kogyo subsequently claimed approximately S$1.35 million from Tactic, comprising of back charges, administrative charges and monies owed under a separate contract.

Tactic did not pay. After making demands, Sato Kogyo called on the bond.

Tactic then successfully applied for and obtained a Court injunction restraining Sato Kogyo from calling on the bond. Sato Kogyo applied to the High Court to set aside the injunction.

Unconscionability

Tactic essentially argued before the High Court that Sato Kogyo's claim was flawed and inflated such that it was not entitled to the sums claimed and, therefore, the bond call in respect of those sums claimed was unconscionable.

In particular, Tactic alleged that Sat Kogyo was not entitled to monies claimed which were owed under a separate project, was not entitled to impose administrative charges, and had not computed the back charges correctly.

The Court emphasised the following principles in connection with a party seeking to establish unconscionability in order to restrain a bond call:

1. The parties are expected to abide by the deal they have struck. The courts will be slow to disrupt the allocation of risk that the parties have agreed [9(a)];

2. Parties resisting a bond call must establish a strong *prima facie* case of unconscionability. This is a high threshold. A prima facie strong piece of evidence does not make a strong prima facie case [9(b)];

3. Unconscionability imports notions of unfairness and bad faith. Unconscionability will not be established if there is a genuine dispute between the parties [9(c)]; and

4. The Court should not carry out a "*protected consideration of the merits of the case*", and should focus on "*breadth rather than depth*" [9(d)].

Decision

The Court allowed Sato Kogyo's application to set aside the injunction on the basis that Tactic had not met the applicable threshold of proving a strong *prima facie* case of unconscionability. In particular:

1. Tactic's attempts to "*slic[e] off*" parts of Sato Kogyo's claim to depress it below the bond amount was "*artificial*". Tactic was "*bringing the court through an accounting exercise*" [13] and [16];

2. It was not "*reasonably apparent that there was unconscionable conduct on Sato Kogyo's part*" as the back charges were "*not so excessive or abusive*": [14]; and

3. Sato Kogyo had provided "*reasoned responses*" to Tactic's allegations that Sato Kogyo had inflated the amounts claimed to justify the call on the bond: [16].

Comment

The Court clearly recognised the danger of a party inflating its claims to try and justify a bond call – a situation which a cynic might say is not unheard of in the construction industry.

However, on the facts, Sato Kogyo's back charges "*were not so excessive or abusive as to establish that it was unconscionably bloating the numbers to justify the call on the bond*".

In other words, the Court seems to have suggested that inflating a claim alone does not necessarily amount to unconscionability, depending on the scale of that inflation (although no guidance was provided as to what would represent a sufficiently "*excessive"* claim).

Further, the Court made clear that it would not carry out a detailed examination of the merits of the underlying claim upon which a bond call is based, nor engage in an "*accounting exercise*" in respect of the same. Rather, it must be "*reasonably apparent*" without carrying out such exercises that there was unconscionable conduct.

Finally, the Court made clear that it is important for the party calling on the bond to provide "*reasoned responses*" to any allegations of unconscionability (at [16]).

Previous authorities have indicated that a failure by a beneficiary to respond to such allegations is a relevant factor for the Court in deciding whether the threshold of a "*strong prima facie case*" has been met. For example, in *Arab Banking Corp B.S.C. v Boustead Singapore Ltd* [2016] 3 SLR 557 the Singapore Court of Appeal held that it could rely on a bank's *"failure to answer ... allegations of abusive conduct and fraud that were made against it to draw an inference that it had acted fraudulently*" when calling on a bond.

However, the decision in *Tactic Engineering* may go slightly further by emphasising the importance of being able to provide a "*reasoned*" response to allegations of unconscionability. In turn, it would not be sufficient for the party calling a bond simply to deny the allegations of unconscionability without providing a coherent explanation.

This could effectively operate as a check on abusive bond calls by putting the onus on the party calling the bond to be able to provide a reasoned rebuttal to any allegations of unconscionability (rather than on the Court to investigate and determine the merit of the underlying claim and those allegations).

Conclusion

The decision in *Tactic Engineering* may provide some comfort to contractors and other parties considering a call on an on-demand bond in respect of a claim which is not fully developed, including from quantum perspective, but which is nevertheless not excessive or markedly inflated, and is made in good faith.

It is clear that the Court will not consider the underlying merits of the claim, nor the build up to its quantum, in great detail. Provided the claim is not clearly excessive or abusive, and the party calling the bond can provide reasoned responses to any allegations of unconscionability, then the counter party is likely to face an uphill struggle in establishing a strong prima facie case of unconscionability and successfully restraining the call.

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