

CONSTRUCTION & PROJECTS

Understanding Your Rights: Responding to Interference with Payment under an Unconditional Performance Bond

Introduction

It has often been said that an unconditional on-demand bond is "as good as cash", and that the bond issuer (usually a bank) must pay the specified sum to the beneficiary upon receipt of a compliant demand. As an unconditional on-demand bond is entirely independent of the underlying contract between the bank's customer and the beneficiary, the bank will generally not concern itself with the merits of any underlying dispute between the beneficiary and its customer.

However, where a beneficiary fails to appreciate the distinction between its substantive dispute under the underlying contract, and the separate issue of its right to be paid pursuant to its demand under the unconditional on-demand bond, it risks inadvertently turning its unconditional bond into a conditional bond, payable only upon proof of its entitlement to receive payment.

This occurred in the recent Singapore Court of Appeal case of *Star Engineering Pte Ltd v Pollisum Engineering Pte Ltd* [2024] SGCA 30 ("**Star Engineering v Pollisum**"), whereby the beneficiary's attempt to stay an injunction action in favour of arbitration had the effect of turning its unconditional on-demand bond into a conditional bond.

In this Update, we look at the Court of Appeal's consideration of the character of an unconditional on-demand bond; the circumstances under which the court will allow interference with a demand under the bond; and the appropriate course of action a beneficiary should take when it has been ostensibly restrained from receiving payment.

Background

The appellant ("**Star Engineering**") and the first respondent ("**Pollisum**") had entered into a construction contract ("**Contract**"), whereby Star Engineering was engaged by Pollisum to design, construct and maintain the works for a construction project. The Contract was based on the REDAS Design and Build Conditions of Contract, with agreed variations in the Particular Conditions of Contract. As required under the Contract, Star Engineering furnished Pollisum with an unconditional on-demand performance bond ("**PB**") issued by the second respondent ("**Great Eastern**") for the sum of S\$856,000.

The Contract contained an arbitration agreement between Star Engineering and Pollisum which covered any disputes in connection with or arising out of the Contract, including any disputes relating to a "call, demand, receipt, payment" under the PB. The PB contained a non-exclusive jurisdiction clause in favour of the Singapore courts.

After a dispute arose between the parties, Pollisum gave notice to terminate the Contract. It further made a demand for payment under the PB ("**Payment Demand**"), claiming that it had incurred rectification costs and significant losses and expenses due to substantial and numerous defects in Star Engineering's works.

In response, Star Engineering commenced an originating application in the High Court ("**OA 1135**"), seeking to restrain Pollisum from receiving payment under the PB and from making any further demand, and to restrain Great Eastern from making any payment under the PB. Star Engineering also obtained temporary restraining orders against the respondents on the same terms.

Pollisum applied for a stay of OA 1135 in favour of arbitration, which was dismissed by the assistant registrar ("**AR**"). Pollisum then appealed against the AR's decision to the High Court Judge ("**Judge**").

Decision of the High Court Judge

The Judge allowed the appeal, granting a stay of OA 1135 in favour of arbitration for the following reasons:

1. The dispute over the Payment Demand fell within the scope of the arbitration agreement in the Contract.
2. There was sufficient reason to stay the court proceedings. The risk of inconsistent findings could be obviated by granting a stay and having the parties deal with the entire issue in arbitration.
3. The Judge was satisfied that Pollisum was ready and willing to arbitrate.

The Judge also granted a stay in relation to Great Eastern for the following reasons:

1. There was an overlap in the parties to the arbitration, between Star Engineering and Pollisum on one hand, and Star Engineering and Great Eastern on the other hand.
2. The two sets of proceedings raised a real risk of overlapping issues being ventilated before different fora among different parties.
3. A case management stay would give effect to the higher-order concern of upholding a valid arbitration agreement between Star Engineering and Pollisum.

Star Engineering appealed against the Judge's decision.

Decision of the Court of Appeal

The Court of Appeal dismissed Star Engineering's appeal and considered the following issues.

Character of the PB as an unconditional bond

The Court of Appeal noted two provisions of the Contract in relation to the PB:

1. Clause 2.1.3B, which provided that a demand on the PB could be restrained only on the ground of fraud.

2. Clause 2.1.3C.2, which provided that any dispute in relation to a call or demand on the PB was to be resolved in arbitration.

These provisions, however, did not change or alter the character of the PB such that it became a conditional bond. The correct interpretation of these provisions taken together was that:

1. Interference with the Payment Demand was only permitted on the ground of fraud.
2. Any such interference should be sought from the court, pursuant to the non-exclusive jurisdiction clause in the PB.
3. Any dispute between Star Engineering and Pollisum under the Contract as to Pollisum's entitlements would be resolved by arbitration.

Principles governing interference with payment under the PB

In general, the courts have upheld demands made under an unconditional on-demand bond on the ground that the bond is a contract between the beneficiary and the bond issuer. A dispute between the parties to the underlying contract will therefore typically be irrelevant to whether payment is to be made pursuant to a demand under such a bond.

Where a restraining order to interfere with payment under the bond is sought, the courts are not concerned with the underlying dispute as to the beneficiary's entitlement to payment under the underlying contract. Rather, the principal question will be whether there are sufficient grounds to interfere, even temporarily, with the beneficiary's right to be paid under the bond. As a starting point, there will be no such interference unless sufficient evidence of fraud or unconscionability is adduced.

On the present facts, the parties had contractually excluded the ground of unconscionability, leaving only the ground of fraud. Applying the above principles, the Court of Appeal would only interfere if Star Engineering could establish a clear case of fraud. It was irrelevant whether the interference was by way of an injunction against Great Eastern as the issuer or against Pollisum as the beneficiary – both were equally impermissible unless there were grounds for interference.

It thus followed that Pollisum should have applied to set aside the temporary restraining order unless it accepted that there was strong *prima facie* evidence that it had acted fraudulently in making the demand. However, it seemed that Pollisum had not appreciated the distinction between its substantive dispute with Star Engineering and the separate issue of its right to be paid pursuant to the Payment Demand. Rather than applying to set aside the temporary restraining order, Pollisum had instead sought to refer the matter to arbitration to determine the precise issue of whether it was entitled to call on the PB. In doing so, it had effectively converted the unconditional on-demand PB into something akin to a conditional bond payable only upon proof of its entitlement to receive payment thereunder.

Having taken that position, it was too late for Pollisum to change course.

Whether OA 1135 should be stayed in favour of arbitration

Star Engineering argued that OA 1135 should not be stayed, submitting that there was a real prospect of inconsistent findings due to the overlapping issues in the dispute between Star Engineering and Pollisum and the dispute between Star Engineering and Great Eastern.

The Court of Appeal rejected Star Engineering's arguments. By Pollisum's actions, the PB was effectively being treated as a conditional bond dependent on Pollisum's entitlement to payment. The

substantive dispute was now solely between Star Engineering and Pollisum. There was no longer any live dispute in relation to Great Eastern, and therefore no reason not to proceed to arbitration.

Concluding Remarks

Star Engineering v Pollisum serves as a reminder of the complexities involved in dealing with unconditional on-demand bonds and the interplay with arbitration agreements in the underlying contract.

For businesses in construction and other sectors where performance bonds are common, the decision also highlights the necessity of clearly distinguishing between disputes over entitlements under the underlying contract and disputes over the right to payment under the performance bond. The failure to do so may result in effectively converting an unconditional bond into a conditional bond, incurring substantial and unnecessary costs and delays.

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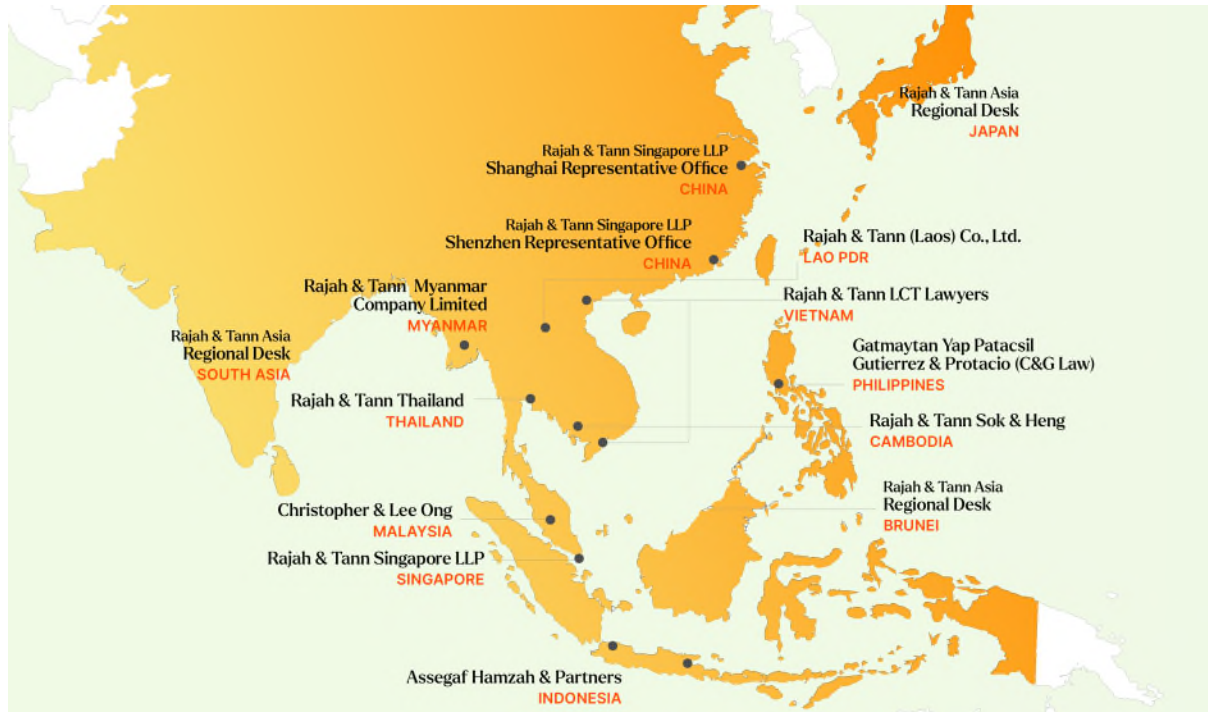
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