

PERFORMANCE BONDS OR BANK GUARANTEES: RISK ALLOCATION IN CONSTRUCTION CONTRACTS

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The construction industry is a high-stakes environment. Projects are capital-intensive, technically complex, and often involve multiple stakeholders across extended timelines. Against this backdrop, the risk of contractor default, project delays, or defective work is ever-present. To mitigate such risks, parties rely heavily on performance bonds or bank guarantees. Though sometimes perceived as ancillary to the main contract, these instruments are pivotal in shaping the allocation of risk between employer and contractor.

Performance bonds or bank guarantees provide employers with swift financial recourse, while contractors accept them as part of the price of admission to major projects. Yet, their invocation is frequently contentious. Employers may call upon them in circumstances where the employers believe that contractors' obligations have not been substantially performed or where remedial works are not satisfactory. Contractors may respond by seeking urgent judicial intervention to restrain what they view as fraudulent or unconscionable conduct. Courts are then faced with a delicate balancing act: upholding the commercial certainty of bonds or guarantees while preventing unconscionable or fraudulent use.

The Malaysian jurisprudence reflects this tension. Influenced by English law, which most of the time recognises fraud as the sole ground for restraining calls, and Singaporean jurisprudence, which has developed unconscionability more expansively, Malaysia has adopted a middle path. This article examines the nature and purpose of performance bonds or bank guarantees, their role in risk allocation, the distinction between conditional and unconditional bonds or guarantees, the principle of autonomy, the grounds upon which a call may be restrained, and the practical implications for employers, contractors, and banks.

The Nature Of Performance Bonds Or Bank Guarantees

A performance bond or bank guarantee is typically a tripartite arrangement. The contractor procures a bond or guarantee from a bank or financial institution in favour of the employer, who is the beneficiary. In consideration of collateral or fees, the bank undertakes to pay a specified sum (commonly between five and ten percent of the contract price) if the contractor defaults on its obligations, depending on the terms of the performance bond or bank guarantee.

Unlike retention sums, which are monies withheld by the employer from sums otherwise payable under the contract, performance bonds or bank guarantees involve an independent undertaking from a third-party guarantor. This independence is significant: the obligation to pay rests on the bank, not on the employer, thereby insulating the employer's cash flow. For contractors, however, it imposes a tangible cost, whether through financing charges or tied-up collateral.

Malaysian courts have consistently recognised that performance bonds or bank guarantees constitute contracts separate from the underlying construction agreement. Once the employer issues a demand that complies with the bond's or guarantee's terms, the bank is obliged to pay, regardless of disputes under the main contract. This principle has been repeatedly affirmed in case law, including the Federal Court case of *Karya Lagenda Sdn. Bhd. v Kejuruteraan Bintai Kindenko Sdn. Bhd. & Anor* [2008] 6 MLJ 636.

Purpose And Risk Allocation

The primary purpose of performance bonds or bank guarantees is twofold: to protect employers against the financial consequences of non-performance or delay, and to incentivise contractors to perform diligently to avoid forfeiture.

For employers, the bond or guarantee functions as an assurance of ready funds. In the event of default, an employer does not need to first prove breach in arbitration or litigation (subject to the terms of the bond or guarantee); the bond or guarantee ensures immediate liquidity to finance remedial works or hire replacement contractors. The bond or guarantee also provides security against the ever-present risk of contractor insolvency, which is not uncommon in the sector.

For contractors, however, providing a bond or guarantee is a voluntary assumption of risk. Contractors must price the risk into their tenders, carefully negotiate the bond's or guarantee's wording, and maintain liquidity to withstand a potential call. A call on the bond or guarantee can have significant financial and reputational consequences, often impacting the contractor's credit standing and ability to secure future projects.

From the bank's perspective, the role is limited. Its obligation is to ensure that the demand complies with the precise wording of the bond or guarantee. Banks often do not concern themselves with disputes under the construction contract. This principle, known as the autonomy of the bond or guarantee, underpins the reliability and commercial value of such instruments.

Conditional And On-Demand Bonds Or Guarantees

Two categories of performance bonds or bank guarantees are generally recognised: conditional (or default) bonds or guarantees and unconditional (or on-demand) bonds or guarantees. A conditional bond or guarantee requires the employer to prove the contractor's default before the bank is obliged to pay. By contrast, an on-demand bond or guarantee requires only that the employer make a written demand in the form prescribed by the instrument, regardless of whether default is established at the time.

The classification turns not only on labels but on wording. The Court of Appeal in *Teknik Cekap Sendirian Berhad v. Public Bank Berhad* [1995] 3 MLJ 449 (affirmed by the Federal Court in [1998] 3 MLJ XXV) held that the operative question is whether the bond expressly makes payment conditional on proof of breach. Where it does not, courts will construe the instrument as on-demand. This principle was reaffirmed in *Suharta Development Sdn Bhd v United Overseas Bank (M) Bhd* [2005] 2 MLJ 762.

In practice, this judicial tendency reflects commercial reality: employers prefer bonds or guarantees that are “as good as cash,” while banks require clarity as to their obligations. For contractors, however, the consequences are severe. Accepting an on-demand bond or guarantee means that payment may be triggered regardless of whether there is an actual breach. Contractors who wish to mitigate this risk must negotiate for conditional wording or certification mechanisms.

The recent Malaysian Court of Appeal decision in *Oxley Rising Sdn. Bhd. v. Ssangyong Engineering & Construction Co. Ltd.* [2023] Appeal No. W-02(C)(A)-274-02/2022 serves as a stark, modern reminder of the severe consequences of agreeing to an unconditional on-demand instrument. The court emphatically reaffirmed that where a guarantee is accepted by all parties as being “on-demand,” its operation is not contingent upon the terms of the underlying construction contract. The court held that it is “quite odd” for a contractor to subsequently argue that conditions from the main contract must be satisfied before a call can be made, stating that if this was the intent, the contractor should not have agreed to an on-demand guarantee in the first place. This shows the critical importance of the initial negotiation phase; once an on-demand bond is executed, its autonomy is virtually absolute.

The Autonomy Principle

Performance bonds or bank guarantees are autonomous instruments. They are independent of the underlying construction contract, and the bank’s obligation is confined to the four corners of the bond or guarantee. Once an employer makes a demand that complies with the bond’s or guarantee’s terms, the bank must pay, without inquiring into disputes between employer and contractor.

This principle was affirmed in *LEC Contractors (M) Sdn Bhd (Formerly Known As Lotteworld Engineering & Construction Sdn Bhd) V Castle Inn Sdn Bhd & Anor* [2000] 3 MLJ 339, where the Court of Appeal made clear that a bank is not required to investigate allegations of breach before paying under a bond. Similarly, in *Karya Lagenda*, the Federal Court held that bonds are to be construed strictly by their terms and not qualified by reference to the underlying contract.

The rationale for this principle is commercial certainty. If banks were obliged to investigate underlying disputes and to act as adjudicator to those disputes, performance bonds or bank guarantees would lose their utility. Employers value them precisely because they provide immediate liquidity. Contractors may consider this harsh, but it reflects the deliberate risk allocation inherent in agreeing to an on-demand instrument.

This principle of autonomy was rigorously applied in the *Oxley Rising* case. The Court of Appeal, binding itself to the apex court precedent in *Karya Lagenda*, ruled that an on-demand guarantee is a "separate document entitling the [employer] to rely on its terms independent of and aside from the formal contract." Therefore, the bank's obligation to pay and the employer's right to call the bond are determined solely by the guarantee's own wording, not by whether a breach of the main contract has been proven.

Grounds For Restraining A Call

Although the autonomy principle is robust, courts recognise narrow exceptions. In Malaysia, there are two grounds upon which a call may be restrained: fraud and unconscionability.

Fraud is the traditional and universally accepted ground. If the employer acts fraudulently in making a demand and the bank has notice of such fraud, the court may restrain payment. The standard is high. Fraud must be clearly established and must go to the root of the demand. Mere allegations of breach, unfairness, or opportunism are insufficient. The English House of Lords case of *United City Merchants (Investments) Ltd v Royal Bank of Canada* [1983] 1 AC 168 and English Court of Appeal case of *Edward Owen Engineering Ltd. v. Barclays Bank International Ltd.* [1978] Q.B. 159 remains the touchstone, and Malaysian courts have followed this approach, such as the Supreme Court case of *Esso Petroleum Malaysia Inc v Kago Petroleum Sdn Bhd* [1995] 1 MLJ 149.

Unconscionability, by contrast, is a more recent development in Malaysian law. Recognised in the Federal Court case of *Sumatec Engineering & Construction Sdn Bhd v Malaysian Refining Co Sdn Bhd* [2012] 4 MLJ 1, unconscionability permits the court to intervene where a call is oppressive, unfair, or in bad faith. The standard is equally high. The doctrine is applied sparingly.

The *Oxley Rising* case provides a clear example of the high bar for establishing unconscionability. The High Court had initially restrained the call, finding it unconscionable because the guarantee was "over-securitized" and the employer had not proven the estimated losses at the time of the call. The Court of Appeal unanimously overturned this decision. It held that for an on-demand guarantee, the concept of being "over-securitized" is irrelevant, and the employer is not required to prove losses or a breach at the point of making the demand. The court emphasised that injunctive relief is a very harsh remedy that restricts a beneficiary from enforcing a substantive right they had bargained for. The plaintiff's failure to meet this "high threshold" was fatal to its case.

In *Perspektif Masa Sdn Bhd v Sabah Development Bank Bhd* [2024] CLJU 2512, the Court of Appeal stressed that contracts asking for an injunction on grounds of unconscionability must make full and frank disclosure to the courts that the bond is unconditional and on-demand. Failure to do so would cause the application to be dismissed.

Contractors seeking to restrain a call also face significant procedural hurdles. Applications are often made on an ex parte basis, requiring strict compliance with

the duty of full and frank disclosure under *Order 29 Rule 1 of the Rules of Court 2012*. In *Kosma Palm Oil Mill Sdn Bhd v Koperasi Serbausaha Makmur Bhd* [2004] 1 MLJ 316, the Court of Appeal underscored that failure to disclose material facts can itself justify setting aside an injunction. In fact, that duty is a continuing one.

The high bar for establishing fraud or unconscionability, combined with the procedural demands of injunction applications, means that successful challenges to bond or guarantee calls remain relatively rare.

Mere contractual or construction disputes are also not enough to elevate to a level of unconscionability (see *Malaysian Resources Corporation Berhad v HSBC Bank Malaysia Berhad & Ors and another suit* [2019] MLJU 813).

Practical Considerations For Employers, Contractors And Banks

For employers, performance bonds or bank guarantees provide a valuable form of security. They ensure that funds are available to remedy contractor default and provide leverage in negotiations.

For contractors, bonds or guarantees represent a significant financial exposure. Contractors must weigh the risks carefully during contract negotiations. Where bargaining power permits, they should negotiate for conditional bonds or guarantees or reduced quantum. Contractors should also be prepared for the possibility of a call by maintaining liquidity or arranging back-to-back securities with subcontractors.

Banks occupy a more neutral role, but one no less important. Their obligation is limited to verifying compliance with the bond's or guarantee's terms. Banks must avoid becoming embroiled in underlying disputes and should adopt a strict compliance approach. While banks may occasionally face injunction proceedings, adherence to the autonomy principle provides the clearest protection.

Comparative Perspectives

The Malaysian position is best understood in comparative context. English law continues to confine judicial intervention to cases of fraud. The fraud exception is well established and strictly applied. The English courts' priority is to preserve the commercial certainty of performance bonds or bank guarantees, even at the expense of fairness in individual cases.

Singapore, by contrast, has embraced unconscionability more fully. In *BS Mount Sophia Pte Ltd v Join-Aim Pte Ltd* [2012] SGCA 28, the Court of Appeal restrained a call where the employer's conduct was deemed oppressive. The Singaporean approach provides contractors with greater protection but does potentially undermine the reliability of on-demand instruments.

Malaysia has chosen a middle course. It recognises unconscionability but applies it sparingly, ensuring that the commercial value of bonds or guarantees is preserved

while retaining a narrow equitable safety valve. The result is a body of law that prioritises certainty but remains open to intervention in very exceptional cases.

Conclusion

Performance bonds or bank guarantees are integral to construction contracts in Malaysia. They operate as tools of risk allocation, providing employers with financial security, disciplining contractors, and offering banks a clear and autonomous obligation. Yet their invocation is inherently contentious, and the courts are often called upon to balance certainty with fairness.

Bonds or guarantees are autonomous and enforceable upon demand. The exceptions of fraud and unconscionability remain narrow, with the latter applied only in truly egregious circumstances. For employers, the key lesson is to exercise calls responsibly, avoiding conduct that could be characterised as abusive or even fraudulent. For contractors, the reality is that furnishing an on-demand bond or guarantee is a deliberate assumption of risk that must be managed strategically. For banks, strict adherence to the autonomy principle remains paramount.

Ultimately, performance bonds or bank guarantees represent the commercial bargain struck by the parties. They are instruments of both security and discipline, designed to keep projects on track. As the recent *Oxley Rising* decision confirms, the Malaysian judiciary remains steadfast in prioritising the commercial certainty of unconditional on-demand guarantees or performance bonds. The courts will not inquire into underlying disputes or allegations of breach to qualify the employer's right to call the bond or bank guarantee. The narrow exceptions of fraud and unconscionability are applied stringently, with the latter requiring a truly egregious case that meets a very high threshold. This jurisprudence reinforces the finality of the commercial bargain struck between the parties at the time of contracting and serves as a clear warning to contractors to manage this risk proactively before the bond or bank guarantee is issued.