The nature of on-demand guarantees

1 In construction contracts, on-demand guarantees or unconditional performance bonds are a means of guaranteeing the performance of the contractor to its employer.

2 On-demand guarantees are similar to letters of credit or promissory notes payable on demand.

3 In **Lombard v Landmark & Others**[1] the following was held:

> *"... The guarantee creates an obligation to pay upon the happening of an event. ...The guarantee was to protect the Academy in the event of default by Landmark and it is to the guarantee that one should look to determine the rights and obligations of the Academy and Lombard."*

4 Lord Denning in **Edward Owen Engineering Ltd v Barclays Bank International Ltd**[2] stated the principle as follows:

> *"A bank which gives a performance guarantee must honour that guarantee according to its terms. It is not concerned in the least with the relations between the supplier and customer; nor with the question whether the supplier has performed his contracted obligation or not; nor with the question whether the supplier is in default or not. The bank must pay according to its guarantee, on demand if so stipulated, without proof or conditions. The only exception is where there is a clear fraud of which the bank has notice."*

5 Similarly, Donaldson LJ held in **Intraco Ltd v Notis Shipping Corporation (The Bhoja Trader)**[3] that:

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[1] Lombard Insurance Co Ltd v Landmark Holdings (Pty) Ltd & Others [2009] 4 ALL SA 322 (2010(2) SA 86) SCA at para 19

[2] [1978] QB 159 with approval in Loomcraft Fabrics CC v Nedbank Ltd and Another 1996 (1) SA 812 (A) and Coface SA Insurance Co Ltd v East Londen Owen Haven 2013 JDR 2712 (SCA)

> *"Irrevocable letters of credit and bank guarantees given in circumstances such as that they are the equivalent to an irrevocable letter of credit have been said to be the lifeblood of commerce. Thrombosis will occur if, unless fraud is involved, the Courts intervene and thereby disturb the mercantile practice of treating rights thereunder as being the equivalent of 'cash in hand'".*

6 In **Compass Insurance Company Ltd v Hospitality Hotel Developments (Pty) Ltd**[4] this *ratio* was taken further when it was held that:

> *"the reason for requiring strict compliance with a letter of credit is that it is an instrument that compels a bank to pay on demand irrespective of the status of the underlying debt"*[5].

7 This allows for international commerce to take place.

ON-DEMAND BONDS AND CONDITIONAL BONDS (SURETYSHIPS)

8 The distinction between an on-demand bond and a conditional bond was dealt with by Brand JA in **Minister of Transport & Public Works, Western Cape & Another v Zanbuild Construction (Pty) Ltd & Another**[6] as follows:

> *"In the parlance of the English authorities the dispute can be usefully paraphrased as being whether the guarantees are 'conditional bonds' (as suggested by Zanbuild) or 'on demand bonds' (as suggested by the department). The essential difference between the two, as appears from these authorities, is that a claimant under a conditional bond is required at least to allege and - depending on the terms of the bond - sometimes also establish liability on the part of the contractor for the same amount. An 'on demand' bond, also referred to as a 'call bond',*

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[3] [1981] 2 Lloyds Rep 256;
[4] 2011 JDR 1179 (SCA)
[5] 2011 JDR 1179 (SCA) at para 9
[6] 2011 (5) SA 528 (SCA) at para 13

on the other hand, requires no allegation of liability on the part of the contractor under the construction contracts. All that is required for payment is a demand by the claimant, stated to be on the basis of the event specified in the bond."

9 In the absence of fraud, or the demand somehow being deficient as measured against the terms of the bond, the Guarantor is obliged to pay the Applicant irrespective of any disputes between the Second Respondent and the Applicant. The Court does not look behind the demand.

THE FRAUD EXCEPTION

10 What would constitute a fraud has been dealt with in a number of cases, the most recent of which is the **Guardrisk Insurance Company Ltd v Kentz (Pty) Ltd**[7] where Theron JA held:

"It would be useful to briefly consider the legal position in relation to the fraud exception. It is trite that where a beneficiary who makes a call on a guarantee does so with knowledge that it is not entitled to payment, our courts will step in to protect the bank and decline enforcement of the guarantee in question. This fraud exception falls within a narrow compass and applies where:

> *'... the seller, for the purpose of drawing on the credit, fraudulently presents to the confirming bank documents that contain, expressly or by implication, material representations of fact that to his (the seller's) knowledge are untrue.'*

Insofar as the fraud exception is concerned, the party alleging and relying on such exception bears the onus of proving it. That onus is an ordinary civil one which has to be discharged on a balance of probabilities, but will not lightly be inferred. In Loomcraft Fabrics CC v Nedbank Ltd and another, it was pointed out that in order to succeed in

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[7] 2013 JDR 2727 (SCA) para 17

respect of the fraud exception, a party had to prove that the beneficiary presented the bills (documents) to the bank knowing that they contained material misrepresentations of fact upon which the bank would rely and which they knew were untrue. Mere error, misunderstanding or oversight, however unreasonable, would not amount to fraud. Nor was it enough to show that the beneficiary's contentions were incorrect. A party had to go further and show that the beneficiary knew it to be incorrect and that the contention was advanced in bad faith. …

Guardrisk contended that the demands under the guarantees were fraudulent as Kentz had not given Brokrew adequate notice within which to remedy the breaches alleged by it. It was argued that Kentz had elected not to rely on its right to summarily terminate the construction contract. Instead, and in terms of the letter dated 24 February 2010, it gave Brokrew seven days written notice to remedy its alleged breaches, when it was, in terms of clause 15.2(d) of the contract, obliged to provide 28 days written notice to Brokrew. Furthermore, so the argument went, Kentz had failed to comply with the provisions of clause 2.5 of the construction contract in that it had not given notice to Brokrew of the clause it intended to rely upon and the amount that was to be paid to it in terms of clause 2.5. For these reasons, it was contended that the termination of the contract by Kentz was premature and unlawful."

11 These allegations proved to be insufficient and/or irrelevant with the result that payment under the guarantee was enforced by the Court.

12 In **Balfour Beatty Civil Engineering v Technical General Guarantee Co Ltd**[8] the Court held that:

"In this assessment one is entitled to remind oneself that the question is not whether Leadrail or its liquidator might be able to show that the

[8] (1999) 68 Con LR 180 at 190-191

sum claimed under the bond was in fact due. Nor is the question whether the beneficiary in the light of the evidence might not have some anxiety as to whether the sum was due and have some anxiety about whether Leadrail might not have a good claim to the return of the money if it is paid by the surety. The question is whether when the demand was made the persons acting on behalf of the plaintiffs knew that the sum claimed was not due from Leadrail, and dishonestly made a demand despite that knowledge."

13 The SCA's finding in **Coface South Africa Insurance Co Ltd v East London Own Haven t/a Own Haven Housing Association**[9] is also significant in this context:

"[15] ... At paragraph 63 Cloete JA said the following:

'The appellant complied with the provisions of clause 5. It was not necessary for the appellant to allege that it had validly cancelled the building contract due to the second respondent's default. Whatever disputes there were or might have been between the appellant and the second respondent were irrelevant to the first respondent's obligation to perform in terms of the construction guarantee.'

[16] Cloete JA recorded that there was no suggestion of fraud on the part of the employer at paragraphs 64 and 65 he said:

'[64] Once the appellant [the beneficiary] had comply with clause 5 of the guarantee, the first respondent [the guarantor] had no defence to a claim under the guarantee. It still has no defence. The fact that an arbitrator has determined that the appellant was not entitled to cancel the contract, binds the appellant - but only vis-à-vis the second respondent [the employer]. It is res inter alios acta so far as the first respondent is concerned. As the cases to which I have referred above make abundantly clear, the appellant did not have to prove that it was entitled to cancel the building contract with the second respondent as a precondition to enforcement of the

[9] 2013 JDR 2712 (SCA)

guaranteed given to it by the first respondent. Nor does it have to do so now.

[65] For these reasons, it is not in my view bad faith for an employer, who has made a proper demand in terms of a construction guarantee, to continue to insist on payment of the proceeds of the guarantee, when the basis upon which the guarantee was called up has subsequently been found in arbitration proceedings between the building owner and the contractor to have bene unjustified. I would add that the fact that the arbitrator's award is final as between the appellant and the second respondent does not mean that it is correct, or that the appellant would have to set it aside before calling up the guarantee, much less that the appellant is acting in bad faith in seeking to enforce payment under the guarantee against the first respondent.'

[17] At this stage it is necessary to consider cases that have come before this Court after Dormell dealing with letters of credit and construction guarantees.

[18] In Casey v First Rand Bank Ltd (608/2012) [2013] ZASCA 131 this court, in relation to a letter of credit, had to deal with an assertion that the principal debt had prescribed. The guaranteeing bank's client sought a declarator to that effect, submitting that the claim that the client had made upon the bank knowing that the claim had prescribed was fraudulent. It was contended that the effect of a declarator that the debt had prescribed was to extend the ambit of legitimate challenges to a letter of credit beyond the narrow confines of the fraud exception. In Casey, Swain AJA noted that:

'(12) ... An irrevocable letter of credit is not accessory to the underlying contract and is distinguishable in law from a suretyship which is accessory to the principal obligation. See ABSA Bank Bpk v De Villiers 2001 (1) SA 481 (HHA).'

Later, he confirmed:

'(14) The distinction sought to be drawn on behalf of Casey and Kimberley is without merit. The issue of the irrevocable letter of

credit by the Bank of America in favour of Firstrand, established a contractual obligation on the Bank of America to pay Firstrand as beneficiary, provided that the conditions specified in the credit were met. Reciprocal obligations in these terms were created by the letter of credit between the Bank of America and Firstrand. An order declaring that Firstrand had no right to draw-down on the letter of credit, must inevitably have as a consequence that the Bank of America was not obliged to honour this draw-down claim. Such an order would infringe upon the autonomy of the irrevocable letter of credit. The argument was advanced simply to circumvent the autonomy of the letter of credit.'

[19] In First Rand Bank Limited v Brera investments CC (385/2012 [2013] ZASCA 25, this court was faced with a situation where the guaranteeing bank sought to rely on events that occurred after demand had been made in terms of the guarantee. In that regard the decision in Dormell was relied upon. Malan JA, preferred the minority view in Dormell. At paragraph 11 of Brera, the autonomy of letters of credit, demand guarantees, performance bonds and similar documents was restated. The dictum in Lombard referred to above was reaffirmed."

14 In **Turkey IS Banhasi v Bank of China**[10] it was found that even the likelihood that it would be found that the creditor had no right to claim on the bond was insufficient to establish fraud.

[10] [1996] 2 Lloyds Rep 611 at 612;

15 The aforementioned cases have now clarified the current legal position in our jurisdiction in relation the *onus* of proof of the available defences to on-demand guarantees.

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