

On-demand bonds: Is substantial compliance enough?

December 14, 2015 | Written by Rob Scott, Nicole Gabryk and Kate Swart

South African courts have historically applied the English law in relation to guarantees or on-demand bonds (referred to collectively as on-demand bonds), and have held that they are equivalent to documentary letters of credit.

The Supreme Court of Appeal has also, on several occasions, articulated the guarantor's obligation to make payment in terms of a letter of credit or on-demand bond.

Thus in *Lombard Insurance Co. Limited v Landmark Holdings (Pty) Limited* 2010 (2) SA 86 (SCA), the Supreme Court of Appeal described an on-demand bond as:

“... not unlike irrevocable letters of credit issued by banks and used in international trade, the essential feature of which is the establishment of a contractual obligation on the part of a bank to pay the beneficiary (seller). ... The bank undertakes to pay provided only that the conditions specified in the credit are met. The only basis upon which the bank can escape liability is proof of fraud on the part of the beneficiary.

The importance of on-demand bonds was previously emphasised by the full bench of the Supreme Court of Appeal in *Loomcraft Fabrics CC v Nedbank Ltd and Another* 1996 (1) SA 812 (A). The Appeal Court quoted the following from the English decision of *Intraco Ltd v Notis Shipping Corporation (The Bhoja Trader)* [1981] 2 Lloyd's Rep 256 (CA):

“Irrevocable letters of credit and bank on-demand bonds given in the circumstances such as that they are the equivalent of 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.

In another decision of our Appeal court, in *OK Bazaars (1929) Ltd v Standard Bank of South Africa Ltd* 2002 (3) SA 688 (SCA), the following was said about letters of credit:

“ The documents that are to be presented (which invariably include documents of title to the goods in question) are stipulated by the customer and the issuing bank generally has no interest in their nature or in their terms ... It's interest is confined to ensuring that the documents that are present conform with its client's instructions (as reflected in the letter of credit) in which event the issuing bank is obliged to pay the beneficiary. If the presented documents do not conform with the terms of the letter of credit the issuing bank is neither obliged nor entitled to pay the beneficiary without the customer's consent.

Guarantors have, in practice, relied on the English law doctrine of strict compliance when assessing their risk in issuing on-demand bonds, and will only make payment in terms of an on-demand bond if the terms and conditions of the on-demand bond are strictly complied with by a beneficiary (when calling for payment under an on-demand bond). The South African courts have in effect applied this doctrine, but have not expressly stated that they are doing so, or that strict compliance with the terms of an on-demand bond is a requirement. Thus, in the case of *Compass Insurance Limited v Hospitality Hotel Developments (Pty) Limited* 2012 (2) SA 537 (SCA), the Supreme Court of Appeal stated that:

“ In my view it is not necessary to decide whether strict compliance is necessary for performance on-demand bonds, since in this case the requirements to be met by [the respondent] in making demand were absolutely clear, and there was in fact no compliance, let alone strict compliance. The on-demand bond expressly required that the order of liquidation be attached to the demand. It was not.

Two very recent Johannesburg High Court judgements however bring the issue of strict compliance to the fore. In these matters the court endorsed substantial compliance with the terms of an on-demand bond.

The case of *Kristabel Developments (Pty) Ltd v Credit On-demand bond Insurance Corporation of Africa Limited* (23125/2014) [2015] ZAGPJHC 264 (20 October 2015) (Unreported), handed down by Satchwell J, involved a call on an on-demand bond issued in terms of a construction contract. The on-demand bond wording required that a demand for payment by the beneficiary "...enclose a copy of the notice of cancellation..." The construction contract was cancelled by the employer (the beneficiary), following an alleged default by the contractor, and the employer delivered a letter of demand to the guarantor based on this cancellation. It was common cause that the notice of cancellation was not attached to the demand, but that it was in the possession of the guarantor, as it had been sent separately by the employer some two weeks prior to making the demand.

The guarantor argued that there had not been 'strict' compliance with the terms of the on-demand bond, in light of the employer's failure to attach the notice of cancellation to the demand, and that it was therefore not obligated to make payment under the on-demand bond.

Satchwell J examined the well-known English and South African cases pertaining to on-demand bonds, and concluded that the courts, in both jurisdictions, have taken an approach that there is a difference between a letter of credit and an on-demand bond. Paraphrasing Staughton LJ in the English decision of *IE Contractors Ltd v Lloyds Bank plc and Rafidain Bank* ([1990] 2 Lloyd's Rep 496 (CA)), the Judge stated that:

“ ...there is less need for a doctrine of strict compliance in the case of performance bonds.

She went on to say that:

“ Our courts have not yet found [sic] necessary to determine whether or not 'strict' compliance is required of the beneficiary under a performance on-demand bond. In *Compass ...* the Supreme Court of Appeal left the issue of 'strict' compliance in the case of on-demand bonds open for decision on another occasion

The Judge ruled that, whilst the employer could have attached a copy of the cancellation to the demand, its failure to do so did not constitute complete non-compliance with the terms of the on-demand bond. The Judge accordingly found that the prior presentation of the cancellation notice by the employer to the guarantor, instead of "... contemporaneous presentation with the demand constitutes, in the circumstances, compliance with the on-demand bond."

The decision in the *Kristabel* case accordingly differs from that of the *Compass* decision. In the *Compass* case, the Supreme Court of Appeal found that the beneficiary's failure to attach the liquidation order to the demand, as required in the wording of the on-demand bond, was fatally defective to the beneficiary's call on the on-demand bond (there being no compliance with the terms of the on-demand bond). In the *Kristabel* judgement, the beneficiary's failure to attach the cancellation notice was deemed to be compliant with the terms of the on-demand. Substantial compliance was therefore considered to be sufficient to trigger an obligation on the guarantor to make payment to the beneficiary.

In the judgement by Fourie J, in *University of the Western Cape v Absa Insurance Company* (100/2015), Gauteng Local Division, Johannesburg (23 October 2015) (unreported, and marked not reportable), a similar approach to that in the *Kristabel* decision was taken by the court. This case also involved a call for payment under an on-demand bond issued in terms of a construction contract. The on-demand bond wording required that a demand be made "...from the Employer to the Guarantor at the Guarantor's physical address calling up this Construction On-demand bond..." The demand was, however, made by the principal agent, on behalf of the employer, on the principal agent's letterhead, and not by the employer.

The guarantor argued that this did not constitute strict compliance with the terms of the on-demand bond and the "... issue [was] therefore whether performance by a representative can be regarded as strict compliance with the terms of the on-demand bond." It must be pointed out that in the wording of the on-demand bond in this case, a distinction was drawn between the employer and the principal agent, as the principal agent was given separate powers and obligations.

Fourie J dismissed the guarantor's defence and reasoned that it was common cause that the principal agent was acting on behalf of the employer, and that representation or agency is generally accepted by the business community. He found that, in this instance, there was no requirement that the employer act personally in calling up the on-demand bond. Fourie J concluded that "...there is no merit in the defence relating to representation". The effect of this judgment is arguably that strict compliance with the terms of an on-demand bond is not required.

Comment:

On-demand bonds, like letters of credit, play an important role in commerce, and not only in the construction sector.

Underwriting Agencies / Managers and/or Insurers who issue on-demand bonds undertake to make payment provided only that the beneficiary complies with the terms and conditions of the on-demand bond. That too is their promise to co-insurers and reinsurers.

If substantial compliance is acceptable, then where is the line to be drawn? If an insurer makes its own determination then how does it proceed consistently, without exposing itself to criticism or allegations of bias?

Uncertainty is then introduced, and that itself may result in thrombosis.

It is not an easy solution to change standard form wordings to record in the wording that strict compliance with the terms of an on-demand bond is a requirement.

If, as in the University of the Western Cape matter, an agent is entitled to make a call on behalf of an employer, then the guarantor may be obliged to pay without enquiry where the agent is bogus – another thrombosis.

Clarity is now required in the interests of commerce and the construction industry.

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