CONSTRUCTION GUARANTEES

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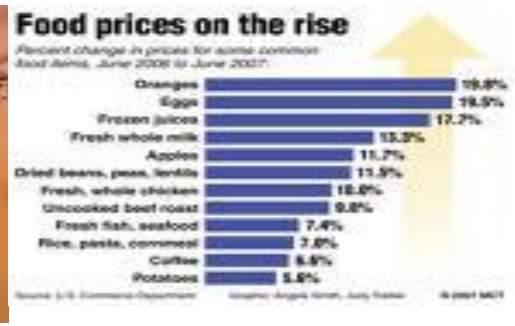

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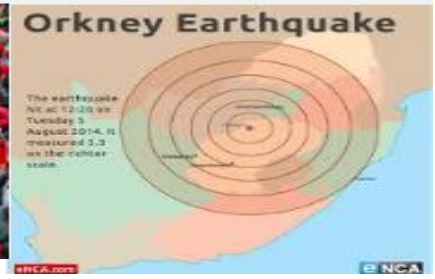

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What is a Construction Guarantee?

Contractors in the construction industry are required to provide various forms of guarantees when they awarded with a contract.

The purpose of any of the guarantees is to provide the Employer (beneficiary of the guarantee) with security in the event of default or non-performance by the Contractor.

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TYPES OF GUARANTEES

Performance Guarantees

Retention Guarantees

Advance Payment Guarantees

Bid bonds / Tender Guarantees

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TYPES OF GUARANTEES

Performance Guarantees

This is most probably the most common form of guarantee, which protects the Employer / Principal against the risk of the contractor failing to perform or comply with the conditions of the contract. The principle purpose is to cover the Employer for the **increased cost of completion** as a result of the non-performance of the contractor. Traditionally, the guarantee amount is equal to 10% of the contract sum.

Retention Guarantee / Bond

The retention bond product effectively replaces the actual retention fund. Most contracts make an allowance for the Employer / Principal to retain a percentage of the funds payable to the contractor during the construction period as a form of **security against default or detective work**. A portion of the funds retained is paid out at the end of the construction period and the balance at the end of the **maintenance (defects liability) period**. It has been shown that funds that are released with a guarantee / bond significantly enhance working capital.

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TYPES OF GUARANTEES

Advance Payment Guarantee / Bond

Some contracts make provision for Employers / Principals to pre-finance a contractor by making payments before commencement of the contract. The Employer / Principal secures such a risk by requiring an advance payment guarantee / bond in return. Usually, the guaranteed amount will decrease in accordance with the percentage of the work certified.

Bid / Tender Bond

When tenders are submitted, they are usually accompanied by Bid / Tender Bonds. The purpose of the Bond is to compensate the employer for costs incurred in the event that the company, which is successful in being awarded the tender, does not or cannot take up the contract. The need to put up a Bid / Tender Bond has the added advantage of creating incentives for responsible bidding / tendering and therefore contributes to eliminating abnormally low Bids / Tenders.

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TYPES OF GUARANTEES

The ultimate purpose of any guarantee is to cover the Employer for the INCREASED COSTS OF COMPLETION as a result of the non-performance or default of the Contractor.


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GUARANTEE TYPES

FIXED VALUE GUARANTEES

The value of the guarantee remains **constant** for the duration of the contract.

VARIABLE

The value of the guarantee **reduces at agreed milestones / stages** of the contract. As example under the JBCC guarantee, the guarantee value reduces as follows:

1. 10.00% of contract value up until 50% completion
2. 7.50% of contract value up until practical completion certificate is issued
3. 4.00% of contract value up to final completion certificate is issued
4. 2.00% of contract value up to final payment

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GUARANTEE TYPES

SURETY

The Guarantor stands as surety and co-principal debtor to the Beneficiary. It creates an **accessory obligation**

DEMAND GUARANTEES

The Guarantor stands as Guarantor to make payment **on demand**. The effect is that the Guarantor must pay regardless of the underlying contractual position or any dispute. An on demand **excludes the concept on an accessory obligation.**

UNCONDITIONAL DEMAND

As the term suggests there are no conditions and the Guarantor simply has to pay on receipt of a written demand to pay a fixed amount of money to the Beneficiary.

CONDITIONAL DEMAND

As the term suggests the Beneficiary has to comply with the conditions as set out in the guarantee in order claim payment from the Guarantor. Payment will then be made on demand. Such terms would include the need to state the Contractor is in default and possibly requiring particulars of the specific default or breach

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INSURANCE VS BANK

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INSURER VS BANK

BANK

On demand bonds originated in the banking sector as Banks **aimed to avoid lengthy disputes or court action** where bonds operated in the same way as **letters of credit**. The Bank would simply pay the claim amount and debit the Contractor's account. For this reason the Banks would take **100% collateral security**.

INSURER

The Insurer approach is to underwrite the Contractor and the Contract based on certain risk assessment criteria. The Insurer aims to satisfy itself in terms of

- Contractor competence and track record
- Contractor profitability
- Contractor solvency
- Contractor security

The Insurer on average required the Contractor to provide between 0% and 40% collateral.

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INSURER VS BANK

How big a part does the Insurance industry play in this market?

Insurers market share in the provision of construction guarantees is roughly about 40%

A rough calculation

Industry premium in bonds approximately	R450 million per annum
Average rate	2.50%
Average bond period	12 months
Bond values	R18 billion per annum
Average 10% bond	R180 billion contract value

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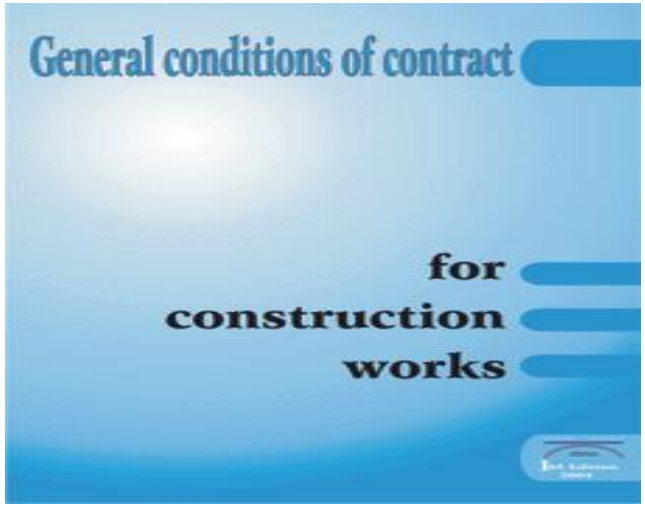
CONTRACTUAL POSITION OF A CONSTRUCTION BOND



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GUARANTEE AND THE CONTRACT

In an on **demand guarantee**

- there is **no concept of an accessory obligation**

- a **primary and independent payment obligation on a 3rd party (Guarantor) to pay <u>upon the happening of an event</u>,** commonly and simply upon a statement by the Beneficiary of the guarantee in support of a demand for payment, that there has been a default

- there is thus **no clear link to the underlying contract** between the Contractor and the Employer

- The effect is that the Guarantor must **pay regardless of the underlying contractual position or any dispute**

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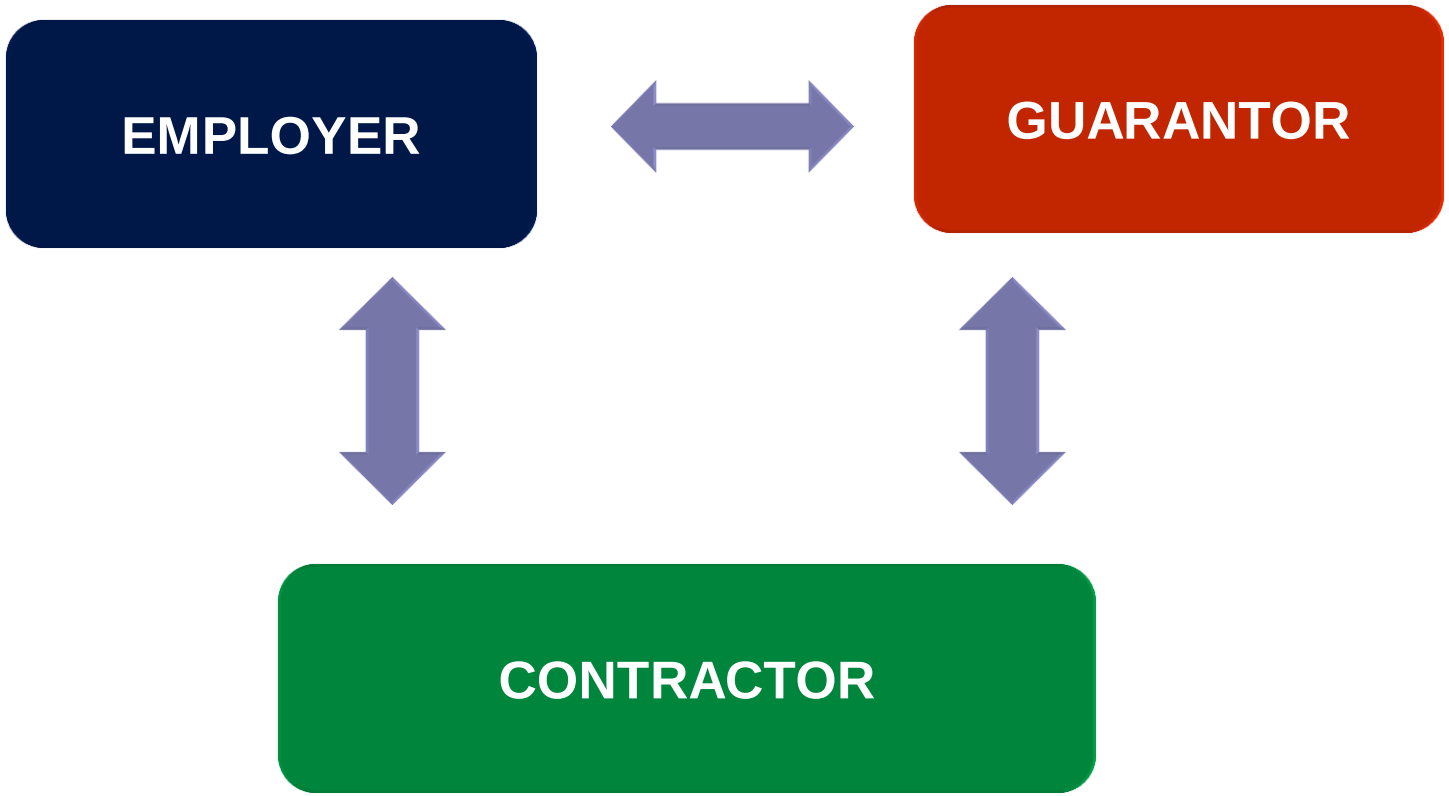
GUARANTEE AND THE CONTRACT



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EMPLOYER/CONTRACTOR/GUARANTOR INTERESTS IN A CONSTRUCTION BOND

LIQUIDATION

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INTERESTS

EMPLOYER INTERESTS

A Contractor's **insolvency is a significant concern** for Employers. A half completed contract that needs to be finished by a replacement contractor will inevitably cost more than the original contract price.

Guarantee thus is **an important tool to mitigate the risk** for the Employer and their project funders.

The principle remains that Employer wants to be covered for damages incurred as a result of the Contractor's default and non-performance.

Type	Security required
Performance	Increased costs of completion
Retention	recovery of retention funds paid to address defects/remedial works
Advance Payment	recovery of the advance funds provided and not repaid
Bid	Costs of re-tendering or re-negotiating

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INTERESTS

CONTRACTOR INTERESTS

A Contractor is required to provide the Employer with such security.

In the event of claim, the **Guarantor seeks to recover the value of the claim from collateral and indemnities held.**

A demand on a guarantee has a severe impact on the Contractor's

1. **Credit status**
2. **Reputation**
3. Can potentially **can lead to the liquidation** of the Contractor. Even if liquidation is avoided, the damage to the Contractor's reputation could **prevent Guarantors from supporting the Contractor on future contracts** and / or drastically altering the premium and collateral terms

It is always in the Contractor's interests to avoid guarantees from being called up. Contractor's rather take contract losses than allow a guarantee to be called up.

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INTERESTS

GUARANTOR INTERESTS

The Guarantor has taken risk on the Contractor in terms of

1. The Contractor's ability to **price the contract correctly, provide the skills and resources** to execute the contract and to complete the contract on time, within budget and with the quality of works to meet the expectations of the Employer

2. The Contractor's ability to have the **available financial resources** and access to materials to execute the contract

3. The Contractor's ability to troubleshoot and **overcome contractual challenges**

4. The Contractor's ability to **work with the Employers appointed Professional Team**

5. The Contractor's ability to **finish the job**

6. The Contractor's ability to refund the Guarantor if any claims do get made on a guarantee

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INTERESTS

GUARANTOR INTERESTS

The Guarantor has equally taken risk on the Employer in terms of

1. The Employer appointing a **professional and competent Principal Agent and Professional Team**

2. The Principal Agent or Employer awarding to the contract to the Contractor on the **right economic terms** and not simply based on a tender price

3. The Employer having the **full available finance budget** to pay for the entire contract **and** future contract variations

4. The Employer **paying the Contractor on time** and as per the Contract terms and conditions

5. The Employer understanding all the factors that can influence the performance of the Contractor which may be out the control of the Contractor

6. The Employer **understanding the purpose of the guarantee** (Increased cost of completion)

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BOND WORDINGS

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BOND WORDINGS

There are hundreds of bond wordings in the market

1. **Industry accepted wordings such as JBCC, GCC, NEC etc**

2. **Employer Prescribed wordings**

3. **Insurer proposed wordings**

There are so many wordings too which have been adaptations of other wordings that it is creating **hybrids of surety and demand wordings** which become **ambiguous** when interpreting the actual nature or intention of the guarantee.

The industry needs to go back towards **standardized wordings** which have the buy-in from ALL STAKEHOLDERS and taking into account the ultimate need to provide **RELIABLE, PERFORMING SECURITY** for the Employer whilst being **FAIR** to the Contractor and preventing the **ABUSE** of the Guarantor's security.

A new standard needs to created as to when the Employer should become entitled to call up a guarantee and when they should be entitled to receive the actual payment/funds.

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BOND WORDINGS

What are the problems or problem terms for Guarantors in demand wordings

If a wording has any reference

- To the guarantee being **unconditional**
- To pay for **any debt or damages**, actual or contingent, direct or indirect, arising from any cause whatsoever and **irrespective of the reason** that caused the default or non-performance of the Contractor
- To the obligation to pay on a first written demand**, without proof of indebtedness** or default
- The guarantor **waiving its rights** to any defense it has available in law
- To the Employer having **no obligation to account** back to the Guarantor
- To the Guarantor having no right to cancel the guarantee

With no link or reference to the Main Building Contract, all these factors lead to a potential abuse or unfair calling of the guarantee.

These are terms that we need to change in the current wordings **WITHOUT AFFECTING THE VALUE AND RELIABILITY OF THE SECURITY TO THE EMPLOYER**

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EXPOSURES TO BOND WORDINGS

EMPLOYER EXPOSURE

It is a natural and agreed requirement that an Employer needs a proper, reliable and enforceable security – **not negotiable**.

CONTRACTOR EXPOSURE

Contractor's in the majority are **not aware of the risk** that they are taking when providing Employers with on demand guarantees and even more unaware that the guarantee does not track or link to the main construction contract. There is a **total shift of power to the Employer** in an on demand guarantee

Contractors do not appreciate, or are **completely unaware of the Courts stance** and views of guarantees. Contractors have a "it won't happen to me" approach to guarantees.

The reality is that the Employer can call on an on demand guarantee for payment by simply stating that the Contractor is in default and as long as they **comply with the terms of the guarantee only**, payment becomes due. Thus even if the Employer is breach of the contract or there is a dispute or arbitration in process in progress, the Employer has a right to demand on the guarantee in an isolated environment.

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EXPOSURES TO BOND WORDINGS

CONTRACTOR EXPOSURE

The ONLY instance that a Court will rule against the payment of a on demand bond is where there is a proven **FRAUD** or male fides (bad faith) event.

The onus is on the Contractor/Guarantor to show the Court beyond a reasonable doubt that an act of fraud was made by the party calling up the guarantee for payment.

Fraud definition – fraud is alleged where there is a **misrepresentation made in the presentation of the documentation in making a demand for payment under the guarantee**.
A Misrepresentation is considered an action that one takes knowing that the information is not correct. In other words one **knowingly misrepresents a material fact** in the making of the demand.

One cannot just 'allege' fraud – one has to show and prove to the Court that a fraud has taken place. The courts are not very tolerant towards the legal fraternity making **baseless allegations** without showing actual misrepresentation or actions that show the fraudulent intent and are quick to throw the matter out. This becomes a reputational matter for the Guarantor and legal fraternity as one cannot present a fraud case without reasonable proof that it does exist.

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EXPOSURES TO BOND WORDINGS

REALITY IS

A GUARANTEE IS SEEN AS A

LETTER OF CREDIT

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CONTRACTOR ERRORS

Contractors have often found themselves ‘licking the wounds’ given their own misunderstanding or poor legal advice given.
Here are some of the misconceptions

The Employer cannot call on the guarantee because:

1. The Employer has not paid us certified amounts
2. The Employer is breach of the main building contract
3. The Employer is not entitled to cancel the contract
4. The Contractor has called a dispute
5. The Contractor is in dispute resolution or arbitration negotiations
6. The Contractor is in negotiation with the Employer
7. The Contractor has cancelled the contract
8. The Contractor is the not the cause of the contract delays
9. The Employer has not suffered any loss
10. The Principal Agent has not performed its duties professionally or has a vendetta against the Contractor
11. The Employer doesn’t have the contract finances to continue
12. The Contractor is in business rescue

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CONTRACTOR ERRORS

Reality is that with an on demand guarantee **contractual disputes or allegations don't matter**.

If the Employer **complies with the terms and conditions of the guarantee** and in the absence of a fraud or deliberate misrepresentation, the guarantee is not a party to any other dispute and must perform in accordance with the guarantee terms.

An on demand guarantee is **principal in nature** and not linked to or subject to any other agreement.

The focus is only on the guarantee document and whether its terms have been strictly complied with.

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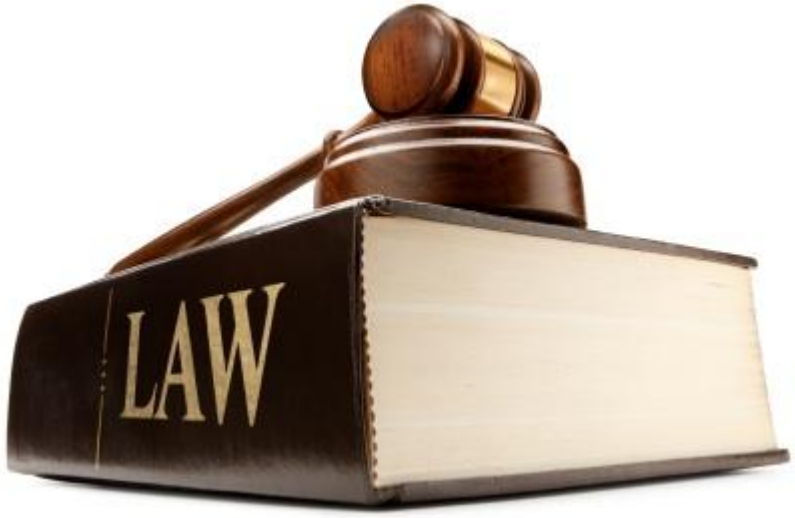
CLAIMS



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CLAIMS

CLAIMS

No need to focus on valid and legal claims – that's why the guarantee exists!

Principle - a guarantee will **always** perform if the demand for payment is **valid, legal** and **in strict compliance** with the terms and conditions of the guarantee.

The concern is the ever **increasing existence of poor, non compliant, abusive, soft demands in the industry and the increasing number of allegations of fraud and bad faith being made by Contractors**.

Some of the worrying experiences in recent years

1. In **tough economic times**, Employers tend to be more aggressive in calling in guarantees

2. Employers see the guarantee as a soft target to **remedy poor contract financial budgeting and management**

3. Employers see the guarantee as a means to **fund the gap** between the original contract and variations or final completed cost / overruns.

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CLAIMS

Some of the worrying experiences in recent years

4. Employers see the guarantee as a ‘big stick’ to force compliance on the Contractor despite possibly being in breach themselves

5. Employers see the guarantee as a soft target to **remedy below standard product specifications agreed to in the tender** or to remedy poor performance of the Contractor they elected knowing the Contractor was elected on price alone

6. Employers are calling in guarantees despite the **existence of a dispute, dispute resolution or arbitration process** being in progress or pending

7. Employers are **contriving circumstances** in order to benefit from the guarantee

8. Employers are calling in guarantees despite knowing that they have caused the non performance of the Contractor

9. Employers are calling in guarantees despite knowing that they have **not paid Contractors** for works completed

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CLAIMS

Some of the worrying experiences in recent years (continued)

10. Employers are calling in guarantees despite knowing that **they themselves are in default** or breach of the contract

11. Employers calling in the **full value of the guarantee despite knowing that the actual damages** is substantially lower in value and the creating fictitious or ballooned expenses to spend the funds

12. Employers calling in guarantees when they have not fulfilled their own obligations in terms of the contract

13. Employers calling in guarantees **too early**. As example calling in a retention guarantee when the contract has not even reached defects liability stage

14. Employers calling in guarantees when they have unlawfully terminated the contract

The difficulty in all of this is that **contractual disputes are no defense** to compliant demand on a guarantee. ONLY fraud and bad faith are grounds to dispute a compliant demand and the onus of proof lies on the Contractor to prove the existence of a fraud or misrepresentation

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CLAIMS

A major concern is point 7

Employers are contriving circumstances in order to benefit from the guarantee

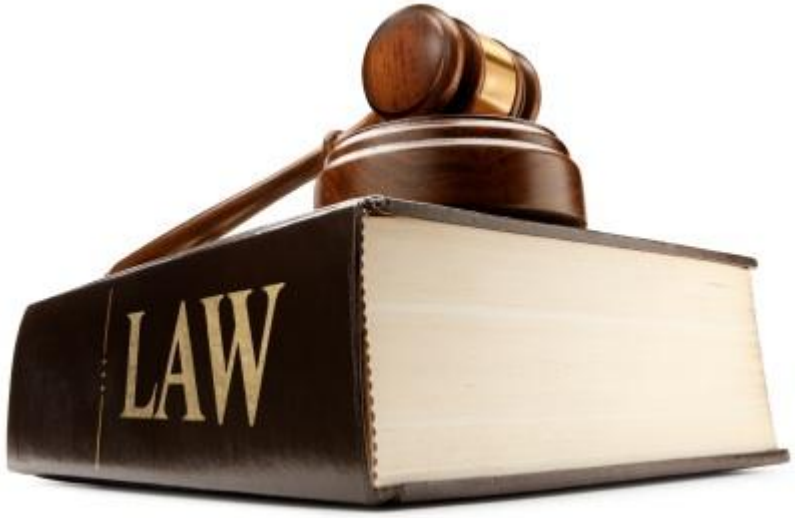
What does this mean?

The Employer is creating a scenario in order to benefit from the guarantee, such as

1. Stating that the Contractor is in default when it **may not actually be in fault**. The guarantee simply requires the Employer to "state" in writing that the Contractor is in default and not necessarily to "prove or provide proof or exact details of the default or breach"
2. Deliberately **frustrating the certification of works completed** in order maintain the full guarantee benefits and rights. As example, not providing practical completion based on non-material items or not providing final completion for non-material items
3. **Cancelling the agreement to simply trigger a right to call the guarantee**. The guarantee simply requires the Employer to confirm that it has cancelled the contract.

ONLY fraud and bad faith are grounds to dispute a compliant demand and the onus of proof lies on the Contractor to prove the existence of a fraud or misrepresentation.

CASE LAW



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CASE LAW

In recent years a **body of case law has been developed in our Courts**, possibly as a result of the increase of the number of on demand guarantees. Each case has questioned or challenged the validity and entitlement of the demand in respect of

1. Is a Contractor entitled to rely on the terms of the underlying building contract **to interdict an Employer** from presenting an on demand guarantee for payment
2. Whether payment under an on demand guarantee should be enforced notwithstanding **a dispute in relation to the underlying building contract** relative to the validity of the Employer's cancellation of the contract
3. Whether **fraud** has been perpetrated by a Principal Agent in terms of the underlying construction contract in order to obtain the benefits of an on demand guarantee
4. Whether the document is a **suretyship** or on demand guarantee
5. Whether an on demand is valid and should be enforced where it is found that the cancellation of the underlying construction contract was determined to have been **unlawful**
6. Whether payment under an on demand guarantee was enforceable where an **Employer has failed to comply strictly** with the terms of the on demand guarantee

There have been 15 decisions in the Supreme Court in the last 4 years

What does this mean?

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CASE LAW

It has created a precedent of the Courts views to the nature and character of these types of securities

Courts decisions make the risk of demand under on demand guarantee very high

Courts regard on demand guarantees as similar to a letter of credit

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CASE LAW

1. Lombard Insurance Co Limited vs Landmark Holdings (Proprietary) Limited and Others 2010 (2) SA 86 (SCA)

2. Kwik Space Modular Buildings Limited vs Sabodola Mining Company SARL and Nedbank Limited (173/09) [2010] ZASCA 15 (March 18, 2010)

3. Dormel Properties 282 CC vs Renasa Insurance Co and Others (491/09) [2010] ZASCA 137 (October 1, 2011)

4. Minister of Transport and Public Works, Western Cape vs Zanbuild Construction (Proprietary) Limited and Absa Bank Limited (68/2010) [2011] ZASCA 10 (March 11, 2011)

5. Compass Insurance Company Limited vs Hospitality Hotel Developments (Proprietary) Limited (756/10) [2011] ZASCA 149 (September 26, 2011)

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CASE LAW

7. First Rand Bank Limited vs Brerea Investments CC (385/2012) [2013] ZASCA 25 (25 March, 2013)

8. Eskom Holdings vs Hitachi Power Africa (139/2013) [2013] ZASCA 101 (12 September 2013)

9. Nedbank Limited vs Hop CD (Menlyn) (Proprietary) Limited vs Proc Props 60 (Proprietary) Limited (108/13) [2013] ZASCA 153 (20 November 2013)

10. Guardrisk Insurance Company Limited and Others vs Kentz (Proprietary) Limited (94/2013) [2013] ZASCA 182 (29 November 2013)

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CASE LAW

Lombard Insurance Co Limited vs Landmark Holdings (Proprietary) Limited and Others 2010 (2) SA 86 (SCA)

Lombard case ruling

1. Landmark has been liquidated and the bond was called
2. Lombard paid the bond and sought recovery from Landmark
3. Landmark rejected Lombard right to recover, citing that the Employer had perpetrated a fraud in order to get the benefits of the bond
4. Lower Court agreed
5. On appeal the Supreme Court ruled otherwise in respect of Lombard's obligation to pay

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CASE LAW

Lombard Insurance Co Limited vs Landmark Holdings (Proprietary) Limited and Others 2010 (2) SA 86 (SCA)

Lombard case ruling

1. On demand guarantees had to be **construed independently** of the underlying construction contract

2. On demand guarantees must be called in accordance with their **terms and conditions**

3. The only basis to escape liability was to **prove fraud** on the party calling up the guarantee

4. On demand guarantees are likened to **letters of credit**

5. Had a fraud been demonstrated **at the time of the demand for payment**, Lombard would not have been obligated to make the payment

   Leading up to Lombard Supreme Court ruling there were a number of lower Court rulings where on demand guarantees was regarded as not unlike a irrevocable letters of credit and there was no intention to create an accessory obligation or suretyship. The SCA endorsed this.

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CASE LAW

Dormel Properties 282 CC vs Renasa Insurance Co and Others (491/09) [2010] ZASCA 137 (October 1, 2011)

1. The guarantee was presented for payment on the basis of an alleged cancellation of the underlying building contract.

2. Before payment of the guarantee, the arbitrator in relation to the underlying contractual dispute, found that the **cancellation had been unlawful**. The arbitration was final and not subject to appeal and had not been taken on review.

3. While the guarantee had been properly presented, there remained **no legitimate purpose to which the guarantee could be applied**. The question was therefore whether the employer was entitled to persist in claiming payment for the guarantee notwithstanding the fact that the employer's cancellation had been found to be unlawful.

4. Our Supreme Court of Appeal held that it would amount to an **academic exercise** without practical effect if the employer were to be granted the order that it sought, as it would immediately have to repay the full amount to the guarantor/or the contractor. Such an order would at best cause additional costs and inconvenience to the parties without any practical effect.

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CASE LAW

Dormel Properties 282 CC vs Renasa Insurance Co and Others (491/09) [2010] ZASCA 137 (October 1, 2011)

Note that later a minority dissenting judgment was given.

This minority judgment is significant in that it was later recognised, by our same Supreme Court of Appeal, in a later judgment (Brera) to be correct. Such recognition reinforced the already established principle that an on-demand bond is a stand-alone document, and that it should in all circumstances (barring fraud), be considered without reference to any underlying dispute (or external event).

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CASE LAW

Minister of Transport and Public Works, Western Cape vs Zanbuild Construction (Proprietary) Limited and Absa Bank Limited (68/2010) [2011] ZASCA 10 (March 11, 2011)

1. This decision concerned an **interpretation of a document** issued by ABSA Bank Limited, and which was described as a guarantee.

2. The wording of the document was **ambiguous**. The question before the Supreme Court of Appeal was whether the document constituted an "*on-demand*" bond, entitling the employer to claim the guaranteed amount purely by alleging that the contractor was in default of the terms of the construction contracts.

3. The Supreme Court of Appeal found that the document in question **did not constitute an on-demand bond**, but rather that it gave rise to liability on the part of the bank akin to a suretyship, such that the employer had in addition to making the demand it had made, to **demonstrate a monetary claim or liability against the contractor in terms of the underlying contract**.

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CASE LAW

Minister of Transport and Public Works, Western Cape vs Zanbuild Construction (Proprietary) Limited and Absa Bank Limited (68/2010) [2011] ZASCA 10 (March 11, 2011)

In finding as it did, the Supreme Court of Appeal relied on the following :

The language of the document was **associated with a suretyship**. The guarantee provided "*security for the compliance of the contractor's performance of obligations in accordance with the contract"* and further that the document bound "*the bank as guarantor for the due and faithful performance by the contractor of all its obligations in terms of the said contract"*. The court did however say that the language of a document was not necessarily decisive.

Comment : while the decision did not take the development of our law in relation to on-demand bonds any further**, it did recognise once again the independent and stand-alone nature of an on-demand bond**. The decision is helpful only in relation to how one ought to interpret an ambiguous document. NB, in the UK the decisions in relation to ambiguity, have in the main gone against the bank or the insurer. There is a tendency to find that the document is an on-demand document.

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CASE LAW

Compass Insurance Company Limited vs Hospitality Hotel Developments (Proprietary) Limited (756/10) [2011] ZASCA 149 (September 26, 2011)

1. This involved an advance payment guarantee (nature of the guarantee is immaterial).

2. The guarantor undertook to pay the employer the full outstanding balance of the advance payment upon receipt of a first written demand from the employer stating that "*A provisional sequestration or liquidation court order has been granted against the Recipient and that the Advance Payment Guarantee is called up in terms of 4.0.* ***The demand shall enclose a copy of the court order***".

3. The demand was duly made, and the demand stated what it was required to state. However a copy of the **court order was not attached** to the demand, but was only delivered months later, and after the expiry of the guarantee.

4. The employer argued that it had complied sufficiently with the terms of the guarantee, and that strict compliance was not necessary.

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CASE LAW

Compass Insurance Company Limited vs Hospitality Hotel Developments (Proprietary) Limited (756/10) [2011] ZASCA 149 (September 26, 2011)

5. The question before our Supreme Court of Appeal was whether there had to be strict compliance with the terms of the guarantee, and if not, whether there had been sufficient compliance.

6. Our Supreme Court of Appeal found that the terms of the guarantee were absolutely clear, and as there had been **no compliance with the terms of the guarantee the guarantee was not payable**

In the circumstances the Supreme Court of Appeal was of the view that it was not necessary to decide whether strict compliance was necessary with the terms of the guarantee.

Comment :
Ironically in finding that there had been no strict compliance, the **Supreme Court of Appeal in fact endorsed strict compliance**, because there had in this instance been partial compliance.
The English law on strict compliance was debated before the court – the English law endorses strict compliance.

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CASE LAW

First Rand Bank Limited vs Brera Investments CC (385/2012) [2013] ZASCA 25 (25 March, 2013)

The guarantor defended a call on a payment guarantee on the basis that the principal agent had, albeit after the call on the guarantee, issued the payment certificate. The guarantor argued that it was entitled to rely upon events that had occurred after the demand had been made, **arguing that as the certificate had been issued, the employer's entitlement to persist with the demand had fallen away**.

The guarantor's argument was dismissed. It was irrelevant to the court that the payment certificate had been issued after the call on the guarantee had been made, as the **autonomy of the guarantee had to be recognised**. The court held that as a proper demand had been made, in terms of the guarantee, the guarantee was payable. Extraneous and subsequent events were irrelevant, and it was **not bad faith** to persist in the call, notwithstanding the eventual issue of the payment certificate by the principal agent.

Comment : here our Supreme Court of Appeal demonstrated its **rigorous insistence on treating a guarantee as autonomous and standalone**

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CASE LAW

Eskom Holdings vs Hitachi Power Africa (139/2013) [2013] ZASCA 101 (12 September 2013)

1. Hitachi provided a number of guarantees drawn on a bank.

2. Eskom called on some of the guarantees for payment on the basis that the guarantees constituted on-demand bonds.

3. Eskom complied with the terms and conditions of the guarantees, which were also found by the court to constitute on-demand bonds.

4. **Hitachi disputed Eskom's entitlement to demand payment, on the basis that Eskom had, extraneous to and independently of the guarantee, undertaken to give Hitachi notice before making its calls**.

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CASE LAW

Eskom Holdings vs Hitachi Power Africa (139/2013) [2013] ZASCA 101 (12 September 2013)

Our Supreme Court of Appeal again, in reliance on the principle established in the **Lombard decision** held that :

The right to call is to be determined **with reference only to the terms and conditions of the guarantee**.
As Eskom had merely given an indication that it was prepared to postpone its decision to demand payment (on condition that in the interim Hitachi remedied its breaches), **it had not given an undertaking, and had therefore also not waived its right to call in terms of the guarantees**.

Comment : the decision raises an interesting point in relation to waiver. It recognises that there may be a waiver of a right to call, through an extraneous event, such as a **clear undertaking** to give notice, or to postpone making a call.
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CASE LAW

Nedbank Limited vs Hop CD (Menlyn) (Proprietary) Limited vs Proc Props 60 (Proprietary) Limited (108/13) [2013] ZASCA 153 (20 November 2013)

1. The guarantee, in this instance, being an on-demand guarantee, provided that the bank shall make payment, upon receipt by the bank, of the landlord's first written demand, which demand shall be **accompanied by the original guarantee.**

2. The lessor made a **first demand**, for part of the guaranteed sum, and presented the original guarantee.
3. The lessor made a **second demand** (this time **without the original guarantee** which had already been handed to the bank).

4. The bank argued that its liability to make payment was discharged, when it paid the first demand.

5. The **Supreme Court of Appeal agreed with the bank**, as on a proper interpretation of the guarantee, the guarantee provided for no more than one payment. The fact that the original guarantee was to be presented together with the first demand, was indicative of this.

The case is once again indicative of our court's applying a **strict approach or interpretation**.

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CASE LAW

Guardrisk Insurance Company Limited and Others vs Kentz (Proprietary) Limited (94/2013) [2013] ZASCA 182 (29 November 2013)

1. The case gives further clarity in relation to the fraud defence.

2. Guardrisk contended that the demands under the guarantees were fraudulent, as the **Employer had not given the contractor adequate notice within which to remedy its breaches**, and had therefore terminated the contract **prematurely and unlawfully**, such that in making its demand, based on a cancellation trigger, it did so in circumstances in which it knew that it did not have the right to cancel, and therefore to call.

3. The court recognised that where a Beneficiary makes a call on a guarantee and **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**.

4. However, in this matter, it was clear that the **Contractor had expressly refused to perform its obligations**. This in the circumstances gave the Employer the right to terminate immediately.

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CASE LAW

Guardrisk Insurance Company Limited and Others vs Kentz (Proprietary) Limited (94/2013) [2013] ZASCA 182 (29 November 2013)

5. The Court accordingly found that Guardrisk **had not established a fraud**, in other words that the Employer knew that its actions were incorrect, and that it advanced its contentions in making the call in bad faith.

   Comment

   This case illustrates a classic example in terms of which a Contractor and/or Guarantor seek to **elevate an underlying contractual dispute, to the realm of a fraudulent defence**. However, what this case does do is to recognise that where a Contractor/Guarantor can demonstrate an underlying fraud, such as a deliberate unlawful cancellation, that may very well found a sustainable fraudulent defence.

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CASE LAW SUMMARY

1. Of these 10 decisions, 5 involved standard form JBCC on-demand bonds.

2. Of the 10 decisions, the Court ordered payment in 7.

3. **The Lombard case laid down the law**.

4. The Dormel decision sought to permit recourse to extraneous matter, although only on a limited basis, if that would render the enforcement of a payment academic.

5. All the other decisions followed the Lombard decision and reinforced it.

6. In the Brera decision, the Court went out of its way to say that the Dormel decision had been wrongly decided. The court did so again in subsequent decisions.

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CASE LAW

The cases demonstrate and are indicative of the following :

7. There have been a **significant number of calls on on-demand guarantees in the last four to five years.**

8. **Our law/juris prudence is now well established**. The framework is clear and simple – calls on bonds must comply strictly with the terms and conditions of the guarantee. The only defence, apart from technical defences in relation to a failure to call in terms of the terms and conditions of the guarantee, is the fraud defence. The parameters of that defence have now been given some meaning/have been defined through the Guardbank decision.

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OWN RECENT EXPERIENCES

Refine has had its own recent cases to demonstrate the risks of a guarantee, employer actions, application of the law and purpose of the bond:

1. Liviero Wilge Joint Venture and Eskom
2. Filcon and City of Cape Town
3. Filcon and United Trust
4. Tshireletso Business Enterprises and Grinaker-LTA Rail Link JV
5. Barrow and K&K Airconditioning
6. Stedone Mechanikos and Department of Health
7. Sanyati and Uthungulu Municipality
8. Sanyati and Sanral
9. Ndala Projects and AngloAmerican

FAIRNESS AND ABUSE

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FAIRNESS AND ABUSE

There are many examples where Employers have **abused their power and rights under the guarantee**. This is substantiated by all the recent Supreme Court cases (which subsequently ignored the contractual issues and .

The concern is the **ever increasing existence of poor, non compliant, abusive, soft demands** in the industry and the increasing number of **allegations of fraud and bad faith** being made by Contractors.

This is particularly concerning given the nature of the ON DEMAND GUARANTEES

SO WHAT IS CONSIDERED FAIR?

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FAIRNESS AND ABUSE

We need to

TAKE OUT THE ABUSE

ON DEMAND GUARANTEES ARE HERE TO STAY

IF WE TAKE OUT THE ABUSE, MAJORITY OFTHE PROBLEMS GO AWAY

A FOUNDATION IS THEN SET FOR ANY GUARANTEE TO PERFORM EXACTLY FOR THE PURPOSES FOR WHAT IT WAS INTENDED

TO PROVIDE SECURITY TO THE EMPLOYER FOR THE DAMAGES INCURRED AS A RESULT OF THE DEFAULT AND NON PERFORMANCE OF THE CONTRACTOR I.E. FOR THE INCREASED COST OF COMPLETION

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FAIRNESS AND ABUSE

We need to consider the exposure of **ALL STAKEHOLDERS**

1. The **Employer** wants security that **will perform** when it is required to perform

2. The **Contractor** wants an **affordable security** and expects the Employer to only call upon a guarantee when it has failed to perform of the contract but also **only after having explored and exhausted all available feasible options to remedy the non performance** and only if the Employer / Principal Agent themselves have not been the underlying cause of the non performance or are themselves not in breach or default

3. The **Insurer/Guarantor** **wants to perform when it is required to perform**. It does not want to be pulled into a dispute into the underlying contract disputes. It wants to **remain independent** in so far as the performance of the guarantee is concerned, however it does not want its guarantee to be abused in any way or called up outside of the true intention and spirit of the contract.

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FAIRNESS AND ABUSE

In the case of an Insurer as Guarantor, the Insurer is not holding Contractor funds. It is holdings its own capital.

Premiums are insignificant to the face value of the risk.

An abuse of on demand guarantees will have dire consequences for the industry as a whole as terms would either become unaffordable to the Contractor or the Insurer will exit the industry.

It has to be a FAIR GAME

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FINDING THE MIDDLE GROUND

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FINDING THE MIDDLE GROUND

Possible Solutions to explore

1. If On Demand guarantees are here to stay

2. We need to create a better guarantee wording with **APPROPRIATE AND FAIR TERMS AND CONDITIONS**

3. The wording can be ON DEMAND but it must be **CONDITIONAL**

4. The wording must be **clear** on what the contractual obligation is and that strict compliance is required when making a demand

5. The wording must require more than just statement that a Contractor is in default. It should firstly be a material breach and furthermore **provide details of what the breach or default is**.

6. The wording must always require the **Employer to account to the Guarantor of how the funds have been applied**

7. The methodology and frequency of this accounting must be fair, transparent and detailed

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FINDING THE MIDDLE GROUND

Solutions

8. **Payment should be made into Trust** and only upon completion of the contract and final accounting should the funds be released to the Employer *** the Guarantor's funds should not be applied to the general financing of the contract*. The Employer should have available funds in terms of the original contract and thus only apply guarantee funds for the damages/increased costs associated to the contract. The final account is to be agreed as far as reasonably possible with the Guarantor and its own project Consultant.

9. The guarantee must be **applied ONLY for the contract works for which it was issued**. It cannot simply be held as ongoing or covering security on any material variations of the works, contract extensions. There is a **common law principle** that if the contract value increases by more than 15% of the original value, it is deemed to be a new contract. Guarantors need **to limit their exposure** to material variations in the value and scope of works and thus need to be part of the notification or consent process

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FINDING THE MIDDLE GROUND

Solutions

10. Demands for payment must be accompanied by an **independent professional Engineer's certification that the Contractor has defaulted**. Thus an independent qualified person is able to confirm that in their **professional opinion** that they agree/confirm that the Contractor is in default. The default allegation then cannot be disputed.

11. Signatures of those parties making the demand for payment are **authenticated**

12. Advising or inviting the **participation of the Guarantor earlier in the process** i.e. a call up on a guarantee should **never be a surprise**

13. In the event of a claim, the Guarantor should be given the right to **source or appoint a Replacement Contractor** which is acceptable to the Employer to complete the works

14. In the event of a claim, the Guarantor should be given the right to **appoint its own Consultant to monitor the completion of the works and costs** associated

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FINDING THE MIDDLE GROUND

Solutions

15. Where a matter is subject to Arbitration, Mediation, Dispute Resolution or Court proceedings, the guarantee shall **not** be called for payment during the mediation process. Should a guarantee be expiring during such process, the Employer shall have the discretion to

    - request an extension of the guarantee or
    - demand payment in terms of the guarantee

    In the event of a demand for payment, the funds are to be paid until Trust until the final decision of ruling of the Arbitration or Court proceeding.

17. Payment should be made **within 7 days** and not immediately on demand – practicality issues

18. Employers should be willing to provide **Payment Guarantees** should they be insisting on on-demand performance guarantees.

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FINDING THE MIDDLE GROUND

Solutions

THE ULTIMATE GOAL IS FOR THE GUARANTEE TO BE FAIR AND TAKE AWAY THE POTENTIAL ABUSE OF THE ON DEMAND GUARANTEE.

ON DEMAND GUARANTEES WERE INITAITED FOR THE BUYING AND SELLER OF GOODS AND NOT FOR PERFORMANCE AND THUS THE NEED TO CREATE A DOCUMENT RELEVANT TO CONSTRUCTION PERFORMANCE THAT IS RELIABLE, FAIR AND WILL PERFORM ON DEMAND.

THANK YOU

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CLOSING

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LIQUIDATION
and
BUSINESS RESCUE

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INVESTING IN EXCELLENCE

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PROTECH
KHUTHELE
HOLDINGS LIMITED

ERBACON

civcon

FILCON

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CONSTRUCTION SOLUTIONS

Vc
Vusela
Construction

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LIQUIDATIONS

LIQUIDATION

Liquidation is any Employer or Guarantor's biggest challenge.

Employer needs to complete the contract and now needs to deal with finding a **replacement contractor** and dealing with delays and **an inevitable increased cost to complete the contract**.

Liquidation automatically triggers a potential claim on the guarantee as the contractor is automatically in default of the contract agreement and in majority cases immediately cancelled.

Liquidator rights

A Liquidator has a right, but no obligation, to negotiate with the Employer to continue with the works as the liquidated company or to negotiate a cession or sub-contract to the main contract in order to complete the job. This is always in the **best interests of the parties**, simply due to the impact of delays and cost when considering the tender process and de-mobilization and mobilization.

Liquidator will only consider if there is a benefit to the estate and creditors.

The guarantee is the single biggest contingent liability in a liquidation.

LIQUIDATIONS

Guarantor rights

A Guarantor **wants** a right to negotiate with the Employer and Liquidator to allow for the continuation of the works as the liquidated company or to negotiate a cession or sub-contract to the main contract in order to complete the job.

This is always in the best interests of the parties, simply due to the impact of delays and cost when considering the tender process and de-mobilization and mobilization and thus the exposure of the guarantee.

Liquidator will only consider if there is a benefit to the estate and creditors.

Employer will consider if they can get the contract completed

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GUARANTEE TYPES

BUSINESS RESCUE

Business Rescue is a good but **misunderstood** concept

BR is a proceeding to **facilitate the rehabilitation of a company that is financially distressed** by providing for:

1. A temporary moratorium on the rights of creditors

2. Temporary supervision of the company (***The management of the company remains in place.)***

3. The development of a Business Rescue Plan (***The plan must result in a company continuing on a solvent basis or provide for a better return for creditors on liquidation)***

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GUARANTEE TYPES

BUSINESS RESCUE

Section 133(2) of the Companies Act 71 of 2008 / Business Rescue

"*During business rescue proceedings,* ***a guarantee or surety by a company in favour of any other person may not be enforced by any person against the company*** *except with leave of the court and in accordance with any terms the court considers just and equitable in the circumstances*"

This is deemed a **general moratorium** of all legal proceedings against a company in business rescue

During business rescue proceedings a guarantee or suretyship provided **by the entity in BR** may not be enforced.

Misconception when it comes to guarantees provided by a 3rd party

The Guarantor (Insurer/Bank) is not in business rescue PLUS the guarantee is a contract between the Guarantor and the Employer/Beneficiary and not the Contractor.

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GUARANTEE TYPES

BUSINESS RESCUE

Thus the Contractor is **not protected from a demand on the guarantee** despite it being in business rescue.

The Western Cape High Court in Investec Bank Ltd vs Bruyns [2012] JOL 28420 (WCC) considered whether a guarantor/surety could use the moratorium afforded to the company under Section 133(2) of the Act in defending a claim for payment in terms of the suretyship.
In this regard the Court held that "*a statutory moratorium in favour of company that is undergoing business rescue proceedings is a defence in personam. It is a* ***personal privilege or benefit in favour of the company*** *…I thus conclude that the statutory moratorium ..does not avail the defendant [the surety/guarantor]..*

The dilemma or challenge it poses for the Guarantor is that as a Creditor it cannot pursue its recovery against the Contractor and thus the interest of the Guarantor in negotiating with the Employer.
On demand guarantees create a principal obligation between Guarantor and Beneficiary. Again unless there is fraud, the guarantee will pay on its terms and conditions despite what would be considered unfair.