Demand guarantees in the construction industry: a comparative legal study of their use and abuse from a South African, English and German perspective

by

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Chapter One: Introductory matters

1.1 Introduction

This chapter serves to introduce the general theme of the doctoral thesis, setting out the motivation and intention behind the work in general, the jurisdictions primarily covered, the methodological approach taken as well as the scope and structure of the research.

The reader will note that in this thesis the pronoun "it" is used predominantly so that a gender-bias is avoided as much as reasonably possible. This aligns to a large extent with the fact that most parties in construction are, in any event, companies or other juristic persons. Furthermore, when referring to a source or judgment for the first time in a chapter the full citation is provided. Thereafter, an abridged citation with a cross-reference to the full citation is given.

1.2 Motivation and intention

Construction can be complex and potentially risky, a fact which increases the need for security for the parties involved. In order to meet the expectations of the industry, such security will have to be comparatively easy to establish, simple to use and reliable in its ability to be converted into cash. Legal certainty, naturally, must be ensured and feature as a fundamental notion. Demand guarantees are highly regarded instruments in this regard. Due to the complexities of construction, however, situations can arise which may lend themselves to the abuse of the guarantees. The focus is therefore on an analysis of the construction-specific situations in which abusive conduct may appear, and on an examination of the different legal systems and their responses to such situations. If no legal solutions have yet been developed in the respective jurisdictions, appropriate responses are suggested where possible.

Over the last decade or so, the South African Supreme Court of Appeal has had to decide numerous cases relating to demand guarantees in construction disputes. Evidenced by the number of decisions, this area forms an important yet contentious aspect of commercial law in South Africa at the moment. Similarly, there have also been several reported High Court decisions in which the law on demand guarantees, in conjunction with construction disputes, has been applied and interpreted. Clearly, guarantee disputes originating from a construction background give rise to fundamental questions regarding the autonomous nature of the instrument and the potential defences to a demand for payment. It is argued, therefore, that the construction arena is well suited also for a more general investigation of the law of guarantees and its current interpretation and application. Furthermore, in her doctoral thesis

on demand guarantees, Kelly-Louw mentioned the limited literature on independent guarantees in South Africa in general.[1] This observation, along with the recent increase of important judgments and academic responses, supports the specific research focus of this thesis.

This thesis is further motivated by the intention to take part in and contribute to the scholarly debate regarding the law of demand guarantees. Placing strong emphasis on the construction industry, it tries to analyse the current legal issues emanating from the use and abuse of guarantees especially in construction projects and provide, when possible, a normative analysis. It is hoped that it will make the law relating to guarantees more accessible to practitioners and professionals working in the construction and guarantee industry. Moreover, it has been argued that "courts are, to an increasing degree, involved in dialogues with one another across the traditional jurisdictional divide" and that "[c]omparative law has been seen to provide courts with persuasive and non-binding arguments".[2] This thesis will prove helpful, it is hoped, in assisting judges to appreciate the different facets and intricacies of the law as it is interpreted and applied in the jurisdictions under consideration, and thereby contribute to sound (comparative) reasoning and the judicial "dialogue". The research strives to make a meaningful contribution to the proper understanding[3] of the law of guarantees, so as to ensure informed choices by the parties involved and foster coherent judgments by the courts seized with such disputes,[4] specifically within a construction context. Accordingly, the title of this doctoral thesis is "Demand guarantees in the construction industry: a comparative legal study of their use and abuse from a South African, English and German perspective", which reflects the considerations and notions introduced so far in this first chapter. The three main jurisdictions under examination, and the reasons for choosing them is explained, briefly, immediately below.

[1] Kelly-Louw *Selective Legal Aspects of Bank Demand Guarantees* (2009) 12 and 19.

[2] Adenas and Fairgrieve "Intent on making mischief: seven ways of using comparative law" in Monateri *Methods of Comparative Law* (2012) 27 par 3 and 29 (alteration by me).

[3] Regard may be had to the remarks by Örücü "Developing comparative law" in Örücü and Nelken *Comparative Law* (2007) 53-54; and Okeke "Methodological approaches to comparative legal studies in Africa" in Mancuso and Fombad *Comparative Law in Africa: Methodologies and Concepts* (2015) 34 37.

[4] Marini "Taking comparative law lightly. On some uses of comparative law in the third globalization" 2012 (3) *University of Perugia Comparative Law Review* 1 17 argues that "[t]he goal of comparative law is […] to supply an argument which justifies a judicial decision" (alteration and omission by me).

1.3 Jurisdictions

As is evident from the title this thesis examines, primarily, three jurisdictions – the law of South Africa, England and Germany.[5] Therefore, it includes a legal system from all three major legal families: (i) English law as possibly the most prominent and influential member of the common-law family; (ii) German law with its wealth of case law and scholarly material as an important jurisdiction from the civil-law background; and (iii) South African law as an important jurisdiction in Africa and one of the "main exponents"[6] of the mixed legal systems.[7] Also, my ability to read English and German played an important part in choosing these particular three systems, as most sources were accessible to me in the original languages. Other jurisdictions that have contributed to this area of law significantly, such as Singapore, Malaysia, Australia, and the USA are referred to occasionally when appropriate. Due to the influence which the three jurisdictions (England, Germany and South Africa) have in regard to legal development in certain parts of the world, the research may also be beneficial to readers from jurisdictions which fall outside of the immediate scope of comparison.

1.4 Research methodology

This thesis applies a comparative approach to analyse the law of demand guarantees in the construction industry, employing and appreciating "comparison as an instrument for understanding, conceptualising and thinking about legal systems and problems". [8] It makes use to a certain extent, despite shortcomings and criticism,[9] of methodological aspects from the so-called functional method.[10] This is not necessarily because it may be[11] that "its

[5] The number of jurisdictions covered is inspired by Siems *Comparative Law* (2014) 15 par b who observed that a "frequent suggestion is that three [legal systems] may be a good number" (insertion by me).

[6] Zimmermann "Double cross: comparing Scots and South African law" in Zimmermann, Visser and Reid *Mixed Legal Systems in Comparative Perspective* (2004) 3.

[7] Du Plessis "Comparative law and the study of mixed legal systems" in Reimann and Zimmermann *The Oxford Handbook of Comparative Law* (2006) 477 *et seq*.

[8] Twomey "Legal salmon: comparative law and its role in Africa" in Mancuso and Fombad *Comparative Law in Africa: Methodologies and Concepts* (2015) 85 87 par 2.

[9] Brand "Conceptual comparisons: towards a coherent methodology of comparative legal studies" 2006/2007 *Brooklyn Journal of International Law* 405 412 *et seq* provides a comprehensive overview and analysis of "putative" and "real" problems in this regard.

[10] Zweigert and Kötz *Einführung in die Rechtsvergleichung* (1996) 33 *et seq*; Valcke and Grellette "Three functions of function in comparative legal studies" in Adams and Heirbaut *The Method and Culture of Comparative Law* (2014) 106 *et seq*; Husa "Research design of comparative law – methodology or heuristics?" in Adams and Heirbaut (n 10) 60-61; Michaels "The functional method of comparative law" in Reimann and Zimmermann (n 7) 339 *et seq*; and Graziadei "The functionalist heritage" in Legrand and Munday *Comparative Legal Studies: Traditions and Transitions* (2003) 100 *et seq*.

theoretical foundations are clear and compelling" but rather because it assists with identifying and analysing "some of the similarities and differences among different legal systems"[12] forming part of this research project. A modified or expanded functional approach is followed,[13] which encourages a rather interwoven elaboration and study of how the different legal systems deal practically with certain issues of especially abusive calls on guarantees. It investigates the legal solutions developed by the different jurisdictions, and to what extent the legal systems produce similar or dissimilar outcomes.

In order to avoid considering only the plain results produced by the different systems, however, the classical functional approach is altered and expanded. Kötz[14] likens the traditional functional approach to a "black box" into which a real life problem is inserted, and a legal solution received. According to him, what happens inside this "black box" is often neither paid attention to, nor is it particularly important for the classical functional method.[15] This thesis, however, seeks to improve on this particular aspect. Because the process of application and the different legal techniques employed by different jurisdictions are sometimes as interesting as the actual legal results themselves,[16] this thesis will expand the research focus through investigating the *plain results* offered by English, South African and German law, and additionally taking into account the *process of legal application and reasoning*. This way, the actual process of the application of laws, how the law "functions and is used" within a system,[17] and the underlying reasoning may equally be scrutinised and put into context whenever appropriate.

In the course of this thesis, decisions from the South African Supreme Court of Appeal and the High Courts are used frequently to illustrate certain legal issues that have

[11] Twomey (n 8) 90 for example, is doubtful whether the functional method and its foundations are clearly defined. She states that "there is generally no common view of what is meant by the functionalist approach". Similar also the remark of Michaels (n 10) 342 ("there is not one ('the') functional method, but many").

[12] Both quotes from Gordley "The functional method" in Monateri (n 2) 107.

[13] See, for example, the remarks of Kischel *Rechtsvergleichung* (2015) 207-208 par 242-244; Glanert "Method?" in Monateri (n 2) 67; and Adams and Bomhoff "Comparing law: practice and theory" in Adams and Bomhoff *Practice and Theory in Comparative Law* (2012) 13; and Siems (n 5) 38.

[14] Kötz "Abschied von der Rechtskreislehre?" 1998 *Zeitschrift für Europäisches Privatrecht (ZEuP)* 493 505 ("Denn man kann es mit einer 'black box' vergleichen, in die auf der einen Seite das 'Problem' eingegeben und von der auf der anderen Seite die 'Lösung' ausgespien wird").

[15] Kötz (n 14) states "Was wirklich in der 'black box' selbst geschieht, wird wenig beachtet und ist für das Funktionalitätsprinzip auch nicht sehr wichtig" (505).

[16] Kötz (n 14) puts it thus: "Oft sind aber die Lösungen nicht so interessant wie das Verfahren, in dem sie erzeugt worden sind" (505).

[17] Okeke (n 3) 44.

emerged recently in the construction context. Using the reasoning of the South African judges as a point of departure, the thesis investigates how German and English law deal with similar problems and compare the different approaches and results. The remark by Zweigert and Kötz, that "the legal system of every society faces essentially the same problems, and solves these problems by quite different means though very often similar results",[18] underscores the comparative research in this thesis. Their particular point is, possibly, even stronger in the original German edition where they state that it is a

> "rechtsvergleichende […] Grunderfahrung, daß zwar jede Gesellschaft ihrem Recht im wesentlichen die gleichen Probleme aufgibt, daß aber die verschiedenen Rechtsordnungen diese Probleme, selbst wenn am Ende die Ergebnisse gleich sind, auf sehr unterschiedliche Weise lösen".[19]

However, the thesis attempts to avoid compiling a mere consecutive, unconnected list of the ways and methods with which the different legal systems evaluate and solve the encountered issues. Instead, cross-references are made whenever appropriate, and a strict separation of the jurisdictions and their respective lines of reasoning disregarded. If the three main legal systems do not provide persuasive and definite answers to legal problems encountered in the construction industry in regard to demand guarantees, then legal thinking and case law from other jurisdictions are scrutinised in order to suggest possible solutions.

1.5 Research scope and structure

This thesis contains eight chapters in total. Chapters One to Four of the thesis set the scene regarding the general construction context and the use of guarantees in commerce, beginning with this Chapter One elaborating on the different jurisdictions examined, the methodology employed and the research scope covered. Chapter Two introduces the main parties encountered in the construction context, explains the construction contract-making process (tendering, procurement and privity of contract), and examines some of the important standard-form contracts used in the industry (JCT and NEC3 in the United Kingdom, the VOB in Germany, JBCC and GCC in South Africa, and FIDIC in international construction). Chapter Three gives an overview of the law relating to demand guarantees, and of the legal frameworks (URDG 758, ISP98 and the UNCITRAL Convention) that may possibly govern the transaction. It introduces the essential parties to a demand-guarantee transaction and the fundamental principles (independence and documentary compliance) of such instruments.

[18] Quote from the English translation by Weir of Zweigert and Kötz *An Introduction to Comparative Law* (1998) 34 par II.

[19] Zweigert and Kötz (n 10) 33 par II (alteration by me).

Possible exceptions to the principle of independence are remarked on. It also deals briefly with procedural issues (interim and final relief). Chapter Four examines the use of demand guarantees in the specific construction context and explores the different types of guarantees most prevalent in the industry (performance, payment, maintenance, tender or bid, repayment, and retention money guarantees). In addition it identifies alternative means of security in construction (accessory guarantees, indemnity contracts, mortgages, cash deposits, insurance, and liquidated damages) and compares them critically to demand guarantees.

The three subsequent chapters (Chapters Five to Seven) can be described as the centre piece of the thesis, and they contain most of the comparative legal research. This part explores various situations in which demand guarantees may potentially be abused in the construction industry, and examines the legal responses of the different jurisdictions. In order to systematise the research, this part of the thesis employs the approach favoured in German scholarship and differentiates between situations in which the conduct of the beneficiary may be abusive in regard to the underlying contract (presented in Chapter Five), and situations in which the terms of the guarantee itself may render the beneficiary's behaviour abusive and impermissible (dealt with in Chapter Six). The particularly problematic issue of so-called negative stipulations is explored separately (in Chapter Seven) due to the potentially conflicting approaches taken by the different jurisdictions.

Chapter Five begins with an extensive comparative analysis of the notion of fraud as an exception to the independence principle. The fraud exception, therefore, lays the foundation for further elaborations on other potential exceptions to independence. This is complemented by an investigation into the *Rechtsmissbrauch* doctrine developed in German law. Furthermore, issues relating to the final determination of the underlying dispute (by way of a final judgment, arbitration award, or the process of construction certification) are presented. Illegality of the main contract and the prescription of the underlying obligation are examined and evaluated. Unconscionable conduct and instances of gross disproportionality between the damages suffered and the amount claimed are dealt with. The doctrine of merger in the context of guarantee transactions and so-called extend-or-pay demands are scrutinised. Accordingly, Chapter Five deals with instances of unfair and potentially impermissible conduct which is abusive in relation to the underlying contract – and which may justify violations of the principle of independence.

Chapter Six is devoted to questionable conduct by the beneficiary in regard to the guarantee directly and its terms. Generally, interference with the payment of guarantees based on instances examined in this chapter does not concern the independence principle. This chapter explores the principle of documentary compliance and issues relating thereto. This includes, *inter alia*, problems of the proper identification of the parties (issues stemming from agency, representation and legal succession of the original beneficiary), the occurrence of partial or multiple demands, and the return of the original guarantee. Furthermore, instruments with variable exposure (so-called variable guarantees) and defences based on such terms of the guarantee, also in regard to retention money guarantees, are examined.

Chapter Seven elaborates on issues relating to the breach of underlying contractual provisions and so-called negative stipulations. As was mentioned above, the breach of negative stipulations has motivated the different jurisdictions to develop legal responses to the problem which may differ considerably from a conceptual point of view. While it has been argued by some that breach of a negative stipulation may give rise to a defence in violation of the independence principle, most authorities disagree and allow judicial intervention only against the beneficiary so as to keep the dispute between the parties to the underlying dispute, and the independence principle intact. Because of its importance and complexity, this thesis dedicates a separate chapter to this particular legal issue.

Chapter Eight completes the thesis with recommendations regarding measures which may be employed to curb the abuse of demand guarantees in the construction industry. Regard is had to, *inter alia*, contract management and conciliation, the drafting of the underlying contract and guarantees, and the use of standard-form instruments and provisional court measures.

Generally, international frameworks are worked into the research as an addition – and sometimes a contrast – to the legal systems primarily dealt with. It has been necessary to limit the scope of the research in some respect. Hence, multi-party guarantees and related features (syndicated guarantees, indirect guarantees, counter guarantees, and advised or confirmed guarantees) are not dealt with. References to documentary letters of credit are only made insofar as this may benefit the discussion relating to demand guarantees. Questions relating to private international law are also mostly excluded from the scope of research. While standard-form construction contracts and standard-form guarantees are commented on throughout the thesis, the multitude of available forms prevents the inclusion of all of them;

instead the research focuses on the documents and forms which are most widely used in the jurisdictions concerned to increase the practical merits of this thesis. Generally, case law and legal writing up to January 2017 have been considered.

Chapter Two: The construction context

2.1 General introductory remarks

This chapter is intended to describe the parties most relevant to the construction industry, the terminology encountered, the process of contract making in construction (the procurement and tendering process and the use of standard-form contracts), the importance of subcontracting and the concept of privity of contract and issues relating to it. As such, it deals with the background against which different guarantees emerge in the construction industry.

In a typical contract of sale, there are often only two parties[1] of immediate relevance: the seller who supplies the goods, and the buyer, who pays for them and accepts delivery. In such a comparatively simple contract, the identification of the obligations of the parties and the risks to which they are exposed, are relatively easy. In the construction industry, on the other hand, one typically encounters not only two parties, connected by contract, but several other parties. Some of them may be linked by contract, but some are not.[2] The technique of sub-contracting, the need for independent, third-party supervision, and the further involvement of suppliers, banks and other financial institutions, are frequently the reason for the complexity of construction contracts. The reality of having to deal with additional parties can be a major concern for lawyers and other professionals involved in construction. Van Deventer accurately observed:

> "The traditional contractual model contemplates two parties, and two parties only, to the typical bilateral contract. Indeed, the very description of this contract, as being 'bilateral', signifies this. Inevitably where third parties are introduced to such a bilateral relationship there are bound to be difficulties in integrating them into this model."[3]

However, one does not necessarily have to join third parties directly in a contract to raise the level of complexity – mere practical and factual interconnectedness suffices. To illustrate some of the difficulties arising out of the multi-faceted construction environment, this chapter examines the parties present, the contractual relationships and obligations arising from it with specific regard to the doctrine of privity of contract and

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[1] Although so-called "string contracts" in which the seller itself is being supplied by another party are often encountered, the reciprocal obligations in such contracts will usually only come into existence between the two immediate parties.

[2] Loots *Construction Law and Related Issues* (1995) 41 par 2.4.3.

[3] Van Deventer *The Law of Construction Contracts* (1993) 182.

sub-contracting, the tendering process and the standard-form contracts found widely in the industry. The purpose of this chapter is to set the scene against which the different guarantees[4] encountered in the construction environment operate. It is not the intention to embark on an in-depth analysis of general construction law, the relationships between the parties concerned or of the existing standard-form contracts in the industry. Nor is this necessary for the purpose of a study focused on demand guarantees and their use and abuse in the construction industry. This chapter, instead, aims simply to provide the essential background necessary for a proper understanding of the ensuing analysis of the issues relating to the use of guarantees in construction.

2.2 Parties and terminology

The numerous parties involved in construction are referred to differently and, unfortunately, a clear, uniform choice of terminology is largely absent. Therefore, it is helpful for certain terms to be clarified upfront.

The main party in any construction project is the employer, who is also sometimes referred to as the client, promoter, principal or (building) owner.[5] Described as the "most essential person",[6] the employer is usually the party that sets the formation of the construction contract in motion.[7] After identifying the expectations and requirements of the project, it will seek to enter into a construction contract with a contractor. The

[4] For a more detailed discussion of guarantees in the construction industry see par 4.3 *et seq* below.

[5] Uff *Construction Law* (2013) 137. *Cf* Loots (n 2) 3 *et seq* ("employer"). See also Sweet "Standard construction contracts in the USA" 2011 *The International Construction Law Review* 101, Sweet "Standard construction contracts: academic orphan" 2011 *The Construction Lawyer* 38, Bailey *Construction Law Volume I* (2011) 19, Kelleher, Mastin and Robey *Smith, Currie and Hancock's Common Sense Construction Law* (2015), and Goldfayl *Construction Contract Administration* (2004), all of whom use the term "owner". Note, however, that the term "owner" or "building/site owner" should to be used with care, as legal systems treat the issue of ownership of buildings, machinery or other objects such as construction material differently. The employer may be the party contracting for the erection of some structure without being or becoming the true legal owner thereof. For this reason it is suggested that the term "(building) owner" should be avoided. The term "employer" is accordingly used in this thesis.

[6] Uff (n 5) 137.

[7] Jansen "The case for the European lex constructionis" 2000 *The International Construction Law Review* 593 600 ("[t]he construction process always starts with the employer specifying his expectations as to quality, time and budget"). See also, in similar vein, Lam, Wang, Lee and Tsang "Modelling risk allocation decision in construction contracts" 2007 *International Journal of Project Management* 485.

contractor is the party who is destined to carry out the work required by the construction contract.[8] As in the case of the employer courts and authors make use of a variety of terms when referring to the contractor, for instance "builder, building contractor, civil engineering contractor",[9] "general contractor",[10] "main contractor"[11] or "head-contractor".[12] In this thesis, the term "contractor" is generally used. The obligations of the contractor can be very specific and limited in scope, but at times also broad and comprehensive and, depending on the stipulations of the contract,[13] may even include "the design, manufacture, delivery, erection and testing of the plant and works".[14] To make matters more complicated, in many – if not most – construction contracts the actual work on the building site is not rendered by the contractor himself, but by subcontractors.[15] This is due to a

> "modern trend [...] towards more and more specialisation in industry and this trend has affected the building industry as much as any. Most aspects of building and engineering works are catered for by specialist contractors and one can safely say that in any major modern building or engineering project a number of specialist contractors will be employed on various parts of the work."[16]

[8] Bailey (n 5) 20; Hughes, Champion and Murdoch *Construction Contracts Law and Management* (2015) 175; and Adriaanse *Construction Contract Law* (2010) *eg* 6 and 118.

[9] Uff (n 5) 138. See also Sweet (n 5 *The Construction Lawyer*) 38.

[10] Hughes, Champion and Murdoch (n 8) 33; and Kelleher, Mastin and Robey (n 5) who use the term "general contractor" (as well as "prime contractor") throughout their book.

[11] *Aspect Contracts (Asbestos) Ltd v Higgins Construction Plc* [2013] EWHC 1322 (TCC).

[12] Burrows "The Contracts (Rights of Third Parties) Act 1999 and its implications for commercial contracts" 2000 *LMCLQ* 540 543.

[13] In this regard it is important to recognise the impact of party autonomy and freedom of contract, as this essentially leads to defining the contractual obligations of the parties. See in this regard Bailey (n 5) 112-113; Hughes, Champion and Murdoch (n 8) 117 par 8.1.1; Sweet (n 5 *The International Construction Law Review*) 101 111; and Charrett "A common law of construction contracts – or vive la difference?" 2012 *The International Construction Law Review* 72 73 *et seq*.

[14] Loots (n 2) 367 par 12.5.1.

[15] Pulkowski "The subcontractor's direct claim in international business law" 2004 *The International Construction Law Review* 31; Ramsden *McKenzie's Law of Building and Engineering Contracts and Arbitration* (2014) 167; Loots (n 2) 54 par 2.8.2; Kelleher, Mastin and Robey (n 5) 248 *et seq*; Uff (n 5) 138-139 and 317-318; and Adriaanse (n 8) 242.

[16] Ramsden (n 15) 167. See also the similar remarks by Goldfayl (n 5) 135-136; Hughes, Champion and Murdoch (n 8) 32-33 and 303-304; and Van Deventer (n 3) 130 par 4.62. Further, note the early observations by Wallace *Construction Contracts: Principles and Policies in Tort and Contract* (1986) 317 par 2 in respect of specialisation in construction.

Therefore, a subcontractor or subcontractors may often in practice carry out the construction work which the main contractor undertook to do as against the employer.[17] The involvement of subcontractors, and possibly sub-subcontractors, leads to the questions regarding privity of contract[18] and the eventual liability of the different parties involved in the construction project towards one another.

Commentators normally distinguish between so-called *nominated subcontractors* as opposed to *domestic subcontractors*. While both types of subcontractors are only bound by an agreement with the (main) contractor and not directly with the employer, the manner in which they are elected or chosen differs. Nominated subcontractors are named or identified by the employer in the main construction contract with the main contractor.[19] This, obviously, "gives the employer and its advisers control of the specialist auction"[20] while preventing a "splitting of responsibility".[21] Yet the nomination of a specific subcontractor "also has an important bearing on time and price",[22] because highly specialised work has to be prepared and arranged before the main contract is concluded; the main contractor does not have to engage in a tendering process for the subcontracting work in depth himself, but can make use of the prior negotiations between the employer and the nominated subcontractor.[23] Subsequently, the nominated subcontractor concludes a contract with the (main) contractor.[24] Although domestic subcontractors eventually enter into contracts with the (main) contractor as well, the manner in which they are chosen is different. As Hughes, Champion and Murdoch state:

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[17] Adriaanse (n 8) 242; and Finsen *The Building Contract* (2005) 31.

[18] See Beale *Chitty on Contracts Volume II Specific Contracts* (2012) 797-798 par 37-177. Further, see par 2.3 below.

[19] Wallace (n 16) 329 par 21-01; Uff (n 5) 138; Adriaanse (n 8) 244; Van Deventer (n 3) 235; and Ndekugri and Rycroft *The JCT 05 Standard Building Contract* (2009) 240 par 8.3.1.

[20] Adriaanse (n 8) 244 (italics omitted).

[21] Dawe "The missing link in construction contracts" 1994 *Juta's Business Law* 15. For an overview of the benefits of subcontractor nomination, see also Hughes, Champion and Murdoch (n 8) 37-38 par 3.2.6.

[22] Hughes, Champion and Murdoch (n 8) 324 par 19.8 (italics omitted by me).

[23] Note the elaboration by Hughes, Champion and Murdoch (n 8) 324 par 19.8, but *cf* Uff (n 5) 320.

[24] Hughes, Champion and Murdoch (n 8) 324 par 19.8; Van Deventer (n 3) 235; and Van Huyssteen and Maxwell *Contract Law in South Africa* (2015) 165 par 344.

> "A 'domestic' sub-contractor, at least in theory, is one in whose selection and appointment the employer normally plays no part, other than simply giving consent where this is required under the terms of the main contract."[25]

Practically speaking this means that the selection is (almost) entirely in the hands of the (main) contractor.[26] If that is the case, one refers to them as being mere domestic subcontractors.[27] Yet, it is important to note that the distinction between nominated and domestic subcontractors is not only in regard to the election process. Rather, it gives rise to implications concerning the rights of action and duties (payment, liabilities and so forth) as between the respective parties (the employer, main contractor and subcontractors).[28] The most important fact to note at this stage, however, is that there is in any event no immediate contractual relationship between the employer and the subcontractor,[29] be it a nominated or simply a domestic subcontractor. The lack of a direct chain of contract between the employer and the subcontractor shapes their respective ability to claim and, naturally, their liability. This subject is returned to in the context of the doctrine of privity of contract below.[30]

The supervision and possibly the design of the project and construction work will usually be done by architects and engineers, often referred to as "construction professionals".[31] Traditionally, they are only contractually linked to the employer,[32] but their field of responsibility may be as broad as comprising not only design, but "making applications for planning permission, preparing the tender documents, the selection of a

[25] Hughes, Champion and Murdoch (n 8) 307 par 19.4.

[26] Note, however, that by virtue of stipulations in the main contract or the particulars of the building project the employer may in some cases still have the right to object to the appointment of certain subcontractors or even subcontracting *per se*. See, for instance, Hughes, Champion and Murdoch (n 8) 305-306 par 19.2; Adriaanse (n 8) 243; and Uff (n 5) 317.

[27] Uff (n 5) 138.

[28] See Beale (n 18) 798 *et seq* (par 37-179 *et seq*). For liabilities in tort of the subcontractor towards the employer and the differences in regard to them being either nominated or merely domestic subcontractors, see Hughes, Champion and Murdoch (n 8) 309 *et seq*. See also the remarks by Ndekugri and Rycroft (n 19) 240 par 8.3.1.

[29] Van Huyssteen and Maxwell (n 24) 165 par 344; Pulkowski (n 15) 36; Nienaber "Construction contracts" in Harms *The Law of South Africa Volume 9* (2015) 39 par 84; Dawe (n 21) 15; Uff (n 5) 318; Hughes, Champion and Murdoch (n 8) 306; Adriaanse (n 8) 242 and 246; and Loots (n 2) 41 and 55.

[30] par 2.3 below.

[31] Van Deventer (n 3) 181; and Adriaanse (n 8) 99.

[32] Uff (n 5) 139; Van Deventer (n 3) 181; Adriaanse (n 8) 99, 100 and 103; and Loots (n 2) 279.

tenderer and […] inspecting and approving the works on behalf of the employer".[33] Also, advising the employer regarding the choosing of a particular type of contract often forms part of the design professional's obligation.[34] For purposes of this thesis it is important to know that such construction professionals, like engineers and architects, at times also assume the role of surveyors (quantity and quality), adjudicators or certifiers.[35] Such a "dual role", that is acting as an impartial figure when certifying or adjudicating while still being perceived as the agent for the employer, however, "can invoke skepticism".[36] This short introduction to the role of construction professionals, but also the other key parties in the construction environment, should suffice at this stage. The issue of certification of the construction work in progress, which usually involves stage payments, retention of sums due under payment certificates and the utilisation of so-called retention-money guarantees are elaborated on in chapters four to six.

2.3 Privity of contract

The most important parties and their respective roles in construction have been dealt with above. This sets the basic background against which the doctrine of privity of contract can be considered. According to this concept, "parties who are not privy to a contract cannot sue or be sued on it".[37] Privity of contract is – with variations and exceptions – an

[33] Adriaanse (n 8) 99 (omission by me). In similar vein see also Hughes, Champion and Murdoch (n 8) 22-23 par 2.5; and Van Deventer (n 3) 181.

[34] Chappell *The JCT Minor Works Building Contract 2005* (2006) 17; and Binnington "GCC 2010?" 2010 *The Civil Engineering Contractor* 50 51. Note also the warning in this regard in Griffiths *JCT 2005 Clause by Clause* (2010) 4.

[35] Uff (n 5) 139-140; Adriaanse (n 8) 101-108; Van Deventer (n 3) 181; and Loots (n 2) 279-288.

[36] Both quotes taken from Rubin, Fairweather and Guy *Construction Claims Prevention and Resolution* (1999) 25. See also Klee *International Construction Contract Law* (2015) 6 par 1.4.1. Further, for the manifold and complicated duties and roles of the architects and engineers, see Van Deventer (n 3) 182-183 par 6.4; Furst and Ramsey *Keating on Construction Contracts* (2012) 3 par 1-004 and 1-005 and 471 par 14-012 *et seq*; Uff (n 5) 139-140; and Nisja "The engineer in international construction: Agent? Mediator? Adjudicator?" 2004 *The International Construction Law Review* 230 231 *et seq*.

[37] Christie and Bradfield *Christie's The Law of Contract in South Africa* (2011) 269. In the often-cited case *Dunlop Pneumatic Tyre Company Ltd v Selfridge and Company Ltd* [1915] AC 847 it was stated by Viscount Haldane LC at 853: "My Lords, in the law of England certain principles are fundamental. One is that only a person who is a party to a contract can sue on it."

accepted doctrine in many, if not all legal systems.[38] It is accordingly not a concept peculiar to or characteristic of only the common law,[39] but recognisable in all jurisdictions, irrespective of their heritage and legal roots. Moreover, it is a doctrine of general application and not restricted to the law of construction contracts. Due to the fact that only contracting parties themselves obtain contractual rights and obligations,[40] the complexity of the construction environment poses challenges to the different parties involved in it. As explained above, there is typically no contract between the subcontractors and the employer, or the construction professionals and the subcontractors. Therefore, even though the actual work on a construction site carried out by subcontractors economically benefits first and foremost the employer, in most cases the subcontractor has no contractual claim for payment against him.[41] The subcontractor must look towards the (main) contractor, with whom it concluded the construction contract. This, obviously, can be detrimental to the subcontractor (or another party in a similar situation); anything causing a delay in payment or a reluctance to pay, such as

[38] Hutchison and Pretorius *The Law of Contract in South Africa* (2012) 21 par 1.8; and Loots (n 2) 41. In German writing it is usually referred to as the "Relativität der Schuldverhältnisse" or the "Relativitätsprinzip". See Hassemer *Heteronomie und Relativität in Schuldverhältnissen* (2007) 1 *et seq*; Weiler *Schuldrecht Allgemeiner Teil* (2016) 41 par 19; Oetker and Maultzsch *Vertragliche Schuldverhältnisse* (2007) 2-3, 202, and 353; Fikentscher and Heinemann *Schuldrecht* (2006) 44-46; Medicus and Lorenz *Schuldrecht I Allgemeiner Teil* (2015) 12-13 par 30; Dauner-Lieb and Langen *Anwaltskommentar BGB Band 2 Schuldrecht* (2005) § 241 par 11; Schellhammer *Schuldrecht nach Anspruchsgrundlagen samt BGB Allgemeiner Teil* (2014) 646 par 1165; Larenz *Lehrbuch des Schuldrechts Erster Band Allgemeiner Teil* (1987) 15 ("relativen Charakter"); and further Markesinis and Unberath *The German Law of Tort* (2002) 62.

[39] Note, however, that Stone and Devenney *The Modern Law of Contract* (2015) par 5.2 nevertheless write that the doctrine of privity of contract "has long been regarded as one of the fundamental characteristics of the English law of contract". Similarly, Burrows (n 12) suggests that the doctrine of privity is "not found (in the same form) in civil law jurisdictions". For a critical view of such remarks, however, see Gronemeyer *Der Vertrag zugunsten Dritter im englischen Common Law* (2009) 42 and 47. Moreover, for the resemblance and interesting interconnectedness of the doctrine of consideration and privity of contract in English law, see Gronemeyer (n 39) 42-48.

[40] Beale *Chitty on Contracts Volume I General Principles* (2012) 1374 par 18-003; Bunni *The FIDIC Forms of Contract* (2005) 58; Peel *Treitel The Law of Contract* (2015) 694 par 14-004 and 722 par 14-044; O'Sullivan and Hilliard *The Law of Contract* (2006) 128; Klass *Contract Law in the United States* (2012) 161; Du Bois *Wille's Principles of South African law* (2007) 814; Van Huyssteen and Maxwell (n 24) 157 par 312; Kötz *Vertragsrecht* (2012) 504 par 1199; Carter and Harland *Cases and Materials on Contract Law in Australia* (1993) 359; and Sutherland "Third-party contracts" in MacQueen and Zimmermann *European Contract Law: Scots and South African Perspectives* (2006) 203 204 par B.

[41] *Norman Kennedy v Norman Kennedy Ltd; Judicial Managers Norman Kennedy Ltd No v Reinforcing Steel Co Ltd* 1947 1 SA 790 (C) per Ogilvie Thompson AJ at 800; and *Administrator, Natal v Magill, Grant and Nell (Pty) Ltd* (in liquidation) 1969 1 SA 660 (A) per Ogilvie Thompson JA at 669.

cash-flow problems, or even more serious, the insolvency of the (main) contractor, can have devastating effects on the subcontractor.[42] Moreover, any call for a set-off or a counter-claim against the actual beneficiary, the employer, must fail, given that there is no contractual link between the employer and the subcontractor. By the same token, the employer can only enforce rectification or compensation for the faulty work of the subcontractor against the (main) contractor with whom it concluded a contract.[43]

This, however, does not mean that there can be no claim against a remote party (that is one who is not privy to the contract). It should be noted that in the absence of privity of contract "there may be a claim on some other basis, for instance vindication or delict or enrichment".[44] In this regard, moreover, contracts for the benefit of a third party, collateral contracts, specific promises, direct warranties, agency, assignment and other means have also been explored in scholarship and by the courts.[45]

Nevertheless, such claims fall short of a proper contractual claim since they are seldom sufficient to satisfy the actual damage.[46] The reasons for the inadequacy of non-contractual claims such as those based on delict are manifold. They relate, *inter alia*, to the doctrine of pure economic loss, the question of foreseeability, remoteness, scope of compensation and protection, causation and prescription.[47]

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[42] See Pulkowski (n 15) 32.

[43] Nienaber (n 29) 39 par 84.

[44] Christie and Bradfield (n 37) 270 (footnotes omitted). See also Chambers *Hudson's Building and Engineering Contracts* (2010) 1232-1233.

[45] For purposes of this thesis and its focus on demand guarantees in the construction context, these brief remarks should suffice. For some proposed alternative solutions, regard may be had to O'Sullivan and Hilliard (n 40) 136 *et seq*; Pulkowski (n 15) 36 *et seq*; Dawe (n 21) 16; Loots (n 2) 41-42, 511 *et seq*; Hackett, Robinson and Statham *The Aqua Group Guide to Procurement, Tendering and Contract Administration* (2007) 17-18; Manson *Law for Civil Engineers* (1993) 60-61; Hughes, Champion and Murdoch (n 8) 309 *et seq* and 327-329; Klass (n 40) 161; Owen *Law for the Builder* (1987) 112; Peel (n 40) 722 *et seq*; Uff (n 5) 198-201; and Adriaanse (n 8) 82. See further Van Huyssteen and Maxwell (n 24) 158 *et seq*; *Frame v Palmer* 1950 3 SA 340 (C) per Van Zyl J at 349; and *Howes and Clover (Pty) Ltd v Ruskin* 1978 1 SA 99 (W).

[46] For the possible advantages of a claim in tort, however, see Hogg *Obligations* (2006) 109-111 with reference to, *inter alia*, the availability of certain defences, limitation of action or notions relating to indemnities by third parties. Note also Thompson "The continuum: a new approach to the place of tort in a contractual matrix" 2006 *Victoria University of Wellington Law Review* 131 133. Even though his article is primarily written with regard to the law in New Zealand, it draws connections to (English) common law.

[47] Harris, Campbell and Halson *Remedies in Contract and Tort* (2005) 296 *et seq*, 310 *et seq* and especially 575-578; Gordley *Foundations of Private Law* (2006) especially 270-284 (tort and pure economic loss);

The relevance of the doctrine of privity of contract in the context of this thesis relates to risk assessment. Especially the default risk in respect of performance or payment (including insolvency) to which each party is exposed needs to be considered[48] and balanced carefully against the potential benefits and profits flowing from the contract. Privity of contract contributes towards these risks. Independent guarantees and other forms of security can diminish such risks.[49] By adding an independent, abstract obligation of a financially reliable party to the business relationship, the creditor gains significant additional security. Such security can assure not only proper performance by the contractor, but also that of subcontractors as well as the repayment of a cash advance.[50] Hence, many standard-form construction contracts suggest or even prescribe the use of guarantees. Letters of credit are also sometimes used in this context.[51] Furthermore, secondary or accessory obligations such as suretyship and conditional guarantees are often encountered in the construction industry.[52] The focus of this thesis, however, falls on independent demand guarantees. The general principles and regulating frameworks governing these guarantees are considered below in chapter three.

Burrows *Understanding the Law of Obligations* (1998) 18; Beale, Fauvarque-Cosson, Rutgers, Tallon and Vogenauer *Cases, Materials and Text on Contract Law* (2010) 94-121; Van Gerven, Lever and Larouche *Tort Law* (2000) 34-35; Kelleher, Mastin and Robey (n 5) 225 *et seq* (regarding pure economic loss and negligence); Wallace (n 16) 35 *et seq*; Giliker and Beckwith *Tort* (2011) 73-88 and 91-106 (economic loss and negligence), 190-198 (remoteness and foreseeability); Loubser "Concurrence of contract and tort" in Blanpain *Law in Motion* (1997) 411 (especially 428-451); Uff (n 5) 437-438 and 457-458; Adriaanse (n 8) 19-25 and 279 *et seq*; and Hughes, Champion and Murdoch (n 8) 172-173.

[48] See the remarks by Loots (n 2) 317 and his catalogue of suggestions relating to inquiries regarding financial stability. Regard may be had to Kelleher, Mastin and Robey (n 5) 249 *et seq*.

[49] Ramphul and Mendelblat "Are the courts' interpretations of bonds and guarantees restricting the security envisaged?" 2011 *The International Construction Law Review* 481; and Wong "Recent developments on demand bonds and guarantees in England and Australia" 2012 *The International Construction Law Review* 51.

[50] See chapter 4 below.

[51] Regarding usage, and the possible differences and similarities between demand guarantees and letters of credit, see chapter 3 below.

[52] For a comparison of primary, independent obligations and mere secondary, accessory means of security, see par 4.5.2 below.

2.4 Contracting and procurement in the construction environment

As noted above, the construction contract forms the basis upon which the different parties in the construction environment set to work. However, it should be borne in mind that the term "construction contract" can have many meanings and it does not always strictly refer to the building of a structure. For example, authors may also use the expression when writing on the relationship between the design professional and the employer in a broader context. Thus, one must not become confused when reading articles or books on "construction contracts", when scholars really elaborate on the relationship between the many parties which do not necessarily concern themselves with the actual construction of a building. The way in which construction contracts are concluded depends very much on the "route" which was required and chosen by the concerned parties. According to Bailey, every procurement process "can be grouped into one of three broad categories: (a) individual negotiations; (b) tendering; and (c) other hybrid versions involving elements of tendering and individual negotiation".[53]

The first route as identified by Bailey is a comparatively familiar one and does not deviate from the usual contract-making process known from other fields of trade and commerce. To create a legally binding construction contract, an offer and, corresponding to it, an acceptance must be exchanged by the parties.[54] This is obviously a concept which is not distinct or typical for the construction sector, but instead a fundamental notion in general contract law. It is simply based on consensus,[55] which "is the basis for every contract".[56] It is therefore sound to state that contract making in the realm of construction

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[53] Bailey (n 5) 218. Ashworth, on the other hand, describes just two ways in *Contractual Procedures in the Construction Industry* (2006) 93 *et seq* ("competition or negotiation"). For a similar view see also Jellinger *Construction Contract Documents and Specifications* (1981) 131 par 8.1.

[54] Uff (n 5) 176; and Ramsden (n 15) 14-15. Note that under (English) common law in many situations a valuable consideration is a further requirement for an agreement to be legally enforceable.

[55] See, for instance, Van der Merwe, Van Huyssteen, Reinecke and Lubbe *Contract General Principles* (2012) 17 and 19; Beale, Fauvarque-Cosson, Rutgers, Tallon and Vogenauer (n 47) 241; Van Deventer (n 3) 16; Zimmermann *Das römisch-holländische Recht in Südafrika* (1983) 102; Zimmermann *The Law of Obligations Roman Foundations of the Civilian Tradition* (1990) 559; Nagel *Business Law* (2015) 18 par 3.02; Collier-Reed and Lehmann *Basic Principles of Business Law* (2006) 51-52; and Quinot "Offer, acceptance and the moment of contract formation" in MacQueen and Zimmermann *European Contract Law: Scots and South African Perspectives* (2006) 74 *et seq*.

[56] Havenga *General Principles of Commercial Law* (2010) 51.

follows mainly the same basic rules as does the conclusion of other contracts. Hence Bailey concludes:

> "At its simplest level, procurement may involve little more than a person finding a builder or a tradesperson from the telephone book or the Internet, and arranging for that person to perform certain work based on an oral agreement, or a short written quote."[57]

Nevertheless, the proliferated use of standard-form contracts in the construction industry also notably influences the contract-formation process.[58] When governmental bodies and public organisations are involved, there are additional provisions and regulations to be adhered to.[59] This holds true not just in the context of construction contracts, but generally for most sectors of public procurement. For the South African context, Bekink explains:

> "When an organ of state in any sphere or any other institution so identified in national legislation contracts for goods or services, it must do so in accordance with a system which is fair, equitable, transparent, competitive and also cost effective. Procurement procedures or policies may further provide for categories of preference in the allocation of contracts and also for the protection or advancement of persons or categories of persons that have been disadvantaged by unfair discrimination. National legislation must again prescribe a framework within which the procurement policy is to be implemented. In accordance with the abovementioned constitutional imperative set out in section 217 of the Constitution, national parliament has enacted the Preferential Procurement Policy Framework Act (PPPFA) [Act 5 of 2000]."[60]

Furthermore, supra-national law or international treaties can be relevant, for instance European Union law[61] or the "Agreement on Government Procurement"[62] in certain

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[57] Bailey (n 5) 218 par 4.02. See also the early remarks of Lipshitz and Malherbe *Malherbe and Lipshitz on Building Contracts* (1979) 72.

[58] See par 2.6 below for a discussion of standard-form contracts in construction.

[59] Bailey (n 5) 218-219. On laws governing public procurement in South Africa see Bolton *The Law of Government Procurement in South Africa* (2007), especially 13-32; Ramsden (n 15) 18-21 par 2.4.1; Bekink *Principles of South African Local Government Law* (2006) 344-346; Burns and Beukes *Administrative Law under the 1996 Constitution* (2006) 170-171; as well as South African Institution of Civil Engineering SAICE *Management Guide to the General Conditions of Contract 2010* (2010) 12-22.

[60] Bekink (n 59) 344-345 (footnotes omitted and insertion by me).

[61] A concise, yet instructive analysis is to be found in Bailey (n 5) 224-251. See further Craig *Procurement Law for Construction and Engineering Works and Services* (1999) 671 *et seq*; Gruber, Gruber, Mille and Sachs *Public Procurement in the European Union* (2009) especially 85 *et seq*; Haratsch, Koenig and Pechstein *Europarecht* (2014) 657-665; Jacoby and Peters *J von Staudingers Kommentar zum Bürgerlichen Gesetzbuch Buch 2 631-651 (Werksvertragsrecht)* (2014) intro paragraph 631 par 108; Trepte *Public Procurement in the EU* (2007) 5 *et seq*; Uff (n 5) 201-205; and Hughes, Champion and Murdoch (n 8) 153-154.

[62] See, for instance, Matsushita, Schoenbaum and Mavroidis *The World Trade Organization Law, Practice, and Policy* (2015) 675 *et seq*.

jurisdictions, which were put in place to foster transparency, (regional or international) competition and thus general efficiency by making tender opportunities public and abolishing discriminatory practices.[63]

2.5 Tendering

Contracting by the means of a calling for tenders is another way of entering into a contract, and, especially in the construction industry, a popular one.[64] Tendering means that the employer to be, often through an architect as its agent,[65] invites the general public or a certain circle of parties to propose contractual offers (tenders) for a particular construction project.[66] Such an invitation for tenders by the employer is considered to be "an invitation to treat, and the tenders themselves […] offers".[67] Once the employer has received the tenders (offers) by the contractors, it is up to him to compare and finally accept one in order to complete the construction agreement. Yet, the employer is commonly under no obligation to agree to the lowest-price tender or any tender at all for that matter.[68] Put differently, the employer almost inverts the first steps of the contract negotiation process: the employer is not offering the making of a contract by communicating a definite, firm offer which a contractor could accept, but rather through inducing interested parties (the tendering contractors) to come forward and formulate offers. The advantages of following the tender route are mainly associated with the

[63] See Van den Bossche and Zdouc *The Law and Policy of the World Trade Organisation* (2013) 50 par 4.1.7; Islam *International Trade Law of the WTO* (2006) 482; Bhala and Kennedy *World Trade Law* (1998) 141; and Lester, Mercurio and Davies *World Trade Law Text, Materials and Commentary* (2012) 714. On the important aspect of preventing corruption in construction finance, see Leistner "Corruption poses a threat to the financing of sustainable infrastructure projects – what can be done against it?" 2015 *Annual Banking Law Update* 11.

[64] Bertrams *Bank Guarantees in International Trade* (2013) 36 par 3-2.

[65] Ramsden (n 15) 14; Finsen (n 17) 50; and Lipshitz and Malherbe (n 57) 73.

[66] Ashworth (n 53) 93 and 96; Uff (n 5) 176; and Delmon "Tendering for the future – you get what you pay for" 2002 *The International Construction Law Review* 446 447.

[67] Hughes, Champion and Murdoch (n 8) 151 par 9.3.4 (omission by me); Ramsden (n 15) 15; Owen (n 45) 84; Uff (n 5) 176; Pike *Engineering Tenders, Sales and Contracts* (1982) 3; Loots (n 2) 19, but note also his remarks at 18; Lipshitz and Malherbe (n 57) 73; Manson (n 45) 98-99; and Bailey (n 5) 220 n 11.

[68] Ashworth (n 53) 96; Kelleher, Mastin and Robey (n 5) 149; Uff (n 5) 176; Ramsden (n 15) 15; Finsen (n 17) 51; and Loots (n 2) 19, 157 and 162.

element of competition.[69] When coupled with the use of one of the many available standard-form contracts in the employer's invitation,

> "[t]ender comparisons are made easier since the risk allocation is [the] same for each tenderer. Parties are assumed to understand that risk allocation and their prices can be accurately compared."[70]

Naturally, the advantageous element of comparability is only fully utilised if the bids by interested contractors are made in strict accordance with the requirements (and the standard-form contract's provisions) set initially by the employer when inviting tenders.[71] Otherwise, the offers by the tendering contractors would hardly be comparable, as they would relate to individual terms and conditions and thus a different risk allocation, making a simple price comparison insufficient.[72] As mentioned above, in cases of governmental agencies or public bodies being involved in procurement procedures, respective domestic regulations or international law may be applicable.[73]

2.6 Standard-form contracts

2.6.1 Introduction

Standard-form contracts are a common way of allocating the risks, forging the contractual scope and generally defining the rights and obligations within a legal relationship.[74] They

[69] Hibberd "The place of standard forms of building contract in the 21st century" (presentation at the Society of Construction Law conference, Wakefield 11 March 2004) 4; Hughes, Champion and Murdoch (n 8) 146 par 9.3.3; Adriaanse (n 8) 6; Hackett, Robinson and Statham (n 45) 94; Ashworth (n 53) 82; Smith, Merna and Jobling *Managing Risk in Construction Projects* (2006) 161; and Delmon (n 66) 446 451-452.

[70] Adriaanse (n 8) 5 (alteration and insertion by me).

[71] See Bunni (n 40) 3 ("common basis for the comparison and evaluation of tenders"). See further Smith, Merna and Jobling (n 69) 162.

[72] See in this regard Delmon (n 66) 456 par (a) and 460 par (b).

[73] See, for instance, Delmon (n 66) 447-448.

[74] Peel (n 40) 263-264 par 7-001; Van der Merwe, Van Huyssteen, Reinecke and Lubbe (n 55) 269 par 9.5.5; Adriaanse (n 8) 5; Martinek *J von Staudingers Eckpfeiler des Zivilrechts* (2014) 354 par 2; Chan Chuen Fye and Gunawansa "Is it the correct time for an ASEAN standard form of building and construction contract?" 2010 *The International Construction Law Review* 448 451; and Jellinger (n 53) 212 par 11.2. See also Lam, Wang, Lee and Tsang (n 7) 486; Rubin, Fairweather and Guy (n 36) 3. For an interesting article on risk allocation and its underlying principles see Brunni "The four criteria of risk allocation in construction contracts" 2009 *The International Construction Law Review* 4, especially 8 *et seq*.

enjoy widespread use in the commercial world, especially in the construction industry.[75] This is even more so the case in the United Kingdom and other (not necessarily common-law) countries, where statutory law governing the contracts concerned is largely absent.[76] It has been argued that if parties were "to negotiate all the terms of [their] contracts, the transaction costs would be wildly excessive and crucial elements of clarity and consistency endangered".[77] This explains the popularity and "the rise of the standard form contract",[78] without which "construction could not function efficiently".[79] But also in jurisdictions which have statutory law relating to construction contracts,[80] defining the

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[75] See, generally, Bunte *Handbuch der Allgemeinen Geschäftsbedingungen* (1982) 2 ("überragende Bedeutung"); Furmston *Cheshire, Fifoot and Furmston's Law of Contract* (2007) 26; Ranieri *Europäisches Obligationenrecht* (2009) 325; Schultheiß *Allgemeine Geschäftsbedingungen im UN-Kaufrecht* (2004) 11; Beatson, Burrows and Cartwright *Anson's Law of Contract* (2010) 5-6 par (ii). For specific reference to construction contracts see Bassenge *Palandt Bürgerliches Gesetzbuch* (2016) intro paragraph 631 par 16; Martinek (n 74) 1111 par 14; Ashworth (n 53) 59; Adriaanse (n 8) 4-5; Sweet (n 5 *The Construction Lawyer*) 38; Hughes, Champion and Murdoch (n 8) 117; Uff (n 5) 179; Powell-Smith *Problems in Construction Claims* (1990) 1; Sweet (n 5 *The International Construction Law Review*) 101 107; and Wallace (n 16) 374 par 23-18. Already more than 40 years ago it was estimated – overall and without specific reference to construction – that the vast majority of contracts concluded are based on standard forms. See, in this regard, Slawson "Standard form contracts and democratic control of lawmaking power" 1971 *Harvard Law Review* 529.

[76] Uff (n 5) 341; Klee (n 36) 92 par 5.4; and Hamilton "Understanding the basic features of Swedish standard construction contracts" 2013 *The International Construction Law Review* 136. For thought-provoking discussions in this regard see also Sweet (n 5 *The International Construction Law Review*) 128-129; and the opening remarks of Wiwen-Nilsson "AB 04 – new Swedish general conditions of contract" 2006 *The International Construction Law Review* 113. Van der Puil and Van Weele *International Contracting* (2014) 149 provide a table of standard-form contracts from various countries (not necessarily common-law jurisdictions).

[77] Sweet (n 5 *The Construction Lawyer*) 38 (alteration by me); see also Bassenge (n 75) intro paragraph 305 par 4; Chan Chuen Fye and Gunawansa (n 74) 452; Griffiths (n 34) 215 ("drafted by legal experts to ensure that the contract terms are clearly expressed"); Hibberd (n 69) 1-2 and 5; Ndekugri and Rycroft (n 19) 1; Sharrock *Business Transactions Law* (2011) 228 par 13; Sweet (n 5 *The International Construction Law Review*) 109; and Van der Merwe, Van Huyssteen, Reinecke and Lubbe (n 55) 269 par 9.5.5. Consider also the rather critical remarks of Bailey (n 5) 117 n 26.

[78] McMeel *The Construction of Contracts* (2007) 160 par 6.06.

[79] Sweet (n 5 *The International Construction Law Review*) 101; and also Sweet (n 5 *The Construction Lawyer*) 38.

[80] Regard may be had to the paragraphs 631 *et seq* BGB (*German Civil Code*), which provides extensive statutory provisions defining, *inter alia*, the duties of the main parties to a construction contract, remedies for defective work and delay, lien, passing of risk, payment and security obligations and limitation of action. In other jurisdictions, for instance in the United Kingdom (Housing Grants, Construction and Regeneration Act 1996), New Zealand (Construction Contracts Act 2002) or Australia's New South Wales (Building and Construction Industry Security of Payment Act 1999), statutory provisions specifically enacted to apply to construction contracts merely cover selected construction issues such as dispute resolution and adjudication, or the securing of payment. See, for example, Smellie "Construction Contract Act 2002: the first case" 2004 *The International Construction*

respective obligations and rights, the remedies and the general scope of a contractual relationship, the need often arises for an even more detailed framework to govern and clarify the reciprocal obligations and rights, tailored to the need of the construction industry.[81] This demand for a meticulously elaborate set of rules is often particularly evident in construction projects. This is possibly due to the general complexities in construction,[82] which are – *inter alia* – of factual, legal and subsequently financial nature.

The *factual complexities* arise, because expectations and requirements in respect of feasibility, design, functionality, capability and durability are frequently not catered for by application of general laws and statutes.

From the *legal perspective* the various chains of contracts, the interwoven processes and responsibilities, and the risks pertaining to certification, security and payment, breach of contract, delays and remedies frequently necessitate a more comprehensive system of rules and stipulations.[83] Again, statutory rules, if available at all, have been perceived as inadequate in this regard.

The *financial implications*[84] arise especially in extensive construction projects (for example such as highways, dams and airports) with their high costs, prolonged planning, financing and building phases and the many risks associated with them.

For these reasons parties to construction contracts incorporate and rely heavily on standard-form contracts. One of the paramount objectives of standard-form contracts is

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Law Review 363; and Dawson "Introduction of a statutory right to progress payment: outline and review of the Building and Construction Industry Security of Payment Act 1999 (NSW)" 2000 *The International Construction Law Review* 611.

[81] See Ganten, Jansen and Voit *Beck'scher VOB-Kommentar Vergabe- und Vertragsordnung für Bauleistungen Teil B* (2013) intro par 2-3; Henssler *Münchener Kommentar Bürgerliches Gesetzbuch Band 4* (2012) paragraph 631 par 126; Preussner, Kandel and Jansen *Beck'scher Online-Kommentar VOB Teil B* (2016) Vorwort; Jacoby and Peters (n 61) intro paragraph 631 par 88; and Messerschmidt and Voit *Privates Baurecht* (2012) intro paragraph 1 *VOB/B* par 1. For a contrary view, or so it seems, see Uff (n 5) 341.

[82] Bunni (n 40) 93 speaks of the "extremely large matrix of hazards and risks" and "inherent characteristics of construction projects". Further, take note of his remarks in Brunni (n 74) 4-5.

[83] See, for instance, Sweet (n 5 *The International Construction Law Review*) 109.

[84] By way of example, see the remarks of Griffiths (n 34) 246 ("[T]he project will involve the expenditure of thousands, if not millions, of pounds and will incur a high level of financial risk"); and Bunni (n 40) especially at 93-94. See further Sweet (n 5 *The International Construction Law Review*) 109.

the fair balancing of risks for all the participating parties in construction.[85] While it is regularly called into question whether, or to what extent, this goal is actually achieved,[86] it is nevertheless acknowledged that there is "the intention at least […] to establish a fair balance between the rights and obligations"[87] and thus an acceptable basis on which the parties may form their relationships. In order to customise the standard-form contracts, however, they are sometimes "amended by the contracting parties to suit their particular needs".[88] This, unfortunately, increases the danger of incoherence, inconsistency and unintended or unfair distribution of risks for the parties[89] – regrettably an effect which runs counter to the very reason for having employed them.

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[85] Bunni (n 40) 3; Osinski "Delivering infrastructure: international best practice – FIDIC contracts: a contractor's view" (presentation at the Society of Construction Law conference, London 12 July 2002) 1; Richards, Bowen, Root and Akintoye "Client strategic objectives: the impact of choice of construction contract on project delivery" 2005 *Construction Law Journal* 473 474-475; Chan Chuen Fye and Gunawansa (n 74) 451-452; Manson (n 45) 97; Norval "The construction guarantee for use with the JBCC principal building agreement – a legal and practical perspective" 1992 *De Rebus* 353; Van Deventer (n 3) 158 par 5.33; and Hughes, Champion and Murdoch (n 8) 118 par 8.1.3.

[86] Netto, Christudason and Kor "The contra proferentem rule and standard forms of construction contracts" 2002 *The International Construction Law Review* 387 ("prepared and revised jointly by a group that should reflect the interests of both the contracting parties", omission of the italics by me) and 388 ("[a]lthough such contracts in their purest form should reflect the interests of the contracting parties, they do not always do so", their reference in n 4 omitted by me); Bailey (n 5) 118 par 3.12; Hughes, Champion and Murdoch (n 8) 119 par 8.1.6; Osinski (n 85) 3-7; and Preussner, Kandel and Jansen *Beck'scher Online-Kommentar VOB Teil B* (2013) Vorwort ("Glaubensfrage") – note, however, that this phrase was omitted in the latest edition (2016). Van Deventer (n 3) 154 par 5.26 expresses confidence regarding the balance of risk and benefit. For similar views regarding some of FIDIC's standard forms, see Wade "FIDIC's standard forms of contract – principles and scope of the four new books" 2000 *The International Construction Law Review* 5 11-12 ("recognized for their principles of balanced risk sharing", "FIDIC's traditional principles of balanced risk sharing"). On the German *VOB* see Jacoby and Peters (n 61) intro paragraph 631 par 88; Messerschmidt and Voit (n 81) intro paragraph 1 *VOB/B* par 2; and BGH *BGHZ* 86, 135 141 and 142 (absent material amendments by either party). For critical views on the German *VOB/B*, however, see Peters "Regelungsbedarf im Baurecht" 2010 *NZBau* 211 212. On the importance of clarity of drafting see Rameezdeen and Rodrigo "Textual complexity of standard conditions used in the construction industry" 2013 *Australasian Journal of Construction Economics and Building* 1 2 *et seq*.

[87] Osinski (n 85) 1 (omission by me).

[88] Bailey (n 5) 118; see also the interesting remarks at 132.

[89] Hibberd (n 69) 3 and 5; Garner *JBCC 2014 and all that* (2014)14; Baird "NEC3 compared and contrasted with African procurement – South Africa" in Forward *NEC3 Compared and Contrasted* (2015) 115 116; Goldfayl (n 5) 7; and Weselik and Hamerl *Handbuch des internationalen Bauvertrags* (2015) 54. Consider also the advice in the preface to the JBCC standard-form contract (ed 6.1) as per Ramsden (n 15) 289; Cumberlege, Buys and Vosloo "A review on the effectiveness of the joint building contracts committee series 2000 principal building agreement – a contractors' perspective" 2008 *Acta Structilia* 97 103-104; Gorley "The missing link in construction contracts" 1994 *Juta's Business Law* 129 130; and the earlier summarising remarks of Brink and Botha *Know the JBCC Agreements Comparison with Existing Documents* (1991) 60-61. Note the list of examples of such amendments in Garner 161-165.

Currently, there are many different standard-form contracts which are drafted for the general needs and expectations of the construction industry, some of which can even be traced back to the nineteenth century.[90] Eventually it would be fair to state that standard-form contracts condense and "reflect the accepted norms and practices of the industry".[91] Drafted by public bodies, private associations, interest groups or big companies,[92] they aim to provide a convenient way of applying a balanced and coherent set of rules and stipulations. It is common to find detailed provisions in them relating to the parties' main obligations and scope of the work, agreements with third parties, payment and the time thereof, certification and supervision, delay and remedies, insurance and security, limitation of claims and alternative dispute resolution. As there are several types of contracts in construction,[93] many issuers of standard-form contracts have devised various forms for the main contract between the employer and contractor, as well as for diverse subcontract agreements, and numerous standardised contracts for the engagement of architects, engineers, quantity surveyors and other construction professionals,[94] as well as standard-form guarantees to be used in conjunction with them.[95]

[90] See Beale (n 18) 719-721 par 37-021 to 37-023; Uff (n 5) 341; Bunni (n 40) 3; Ashworth (n 53) 59; Bailey (n 5) 116-117; Powell-Smith (n 75) 1; Broome and Hayes "A comparison of the clarity of traditional construction contracts and of the new engineering contract" 1997 *International Journal of Project Management* 255 256; Hackett, Robinson and Statham (n 45) 95; Furst and Ramsey (n 36) 804 par 20-002; and Hibberd (n 69) 1. Additionally, Forward *NEC3 Compared and Contrasted* (2015) provides a very comprehensive list and comparative analysis of popular standard-form contracts used in construction in the United Kingdom and throughout the world.

[91] Van Deventer (n 3) 156 par 5.30. See also his similar remarks at 153 (par 5.33), as well as Sweet (n 5 *The International Construction Law Review*) 104.

[92] Van der Puil and Van Weele (n 76) 147 par 8.5; Bailey (n 5) 118; Weselik and Hamerl (n 89) 50 par A; Sweet (n 5 *The International Construction Law Review*) 101; Chan Chuen Fye and Gunawansa (n 74) 451-452; Garner (n 89) 13-14 and 158; and Adriaanse (n 8) 5.

[93] For instance the main construction contract between employer and contractor, subcontracts, contracts engaging architects and engineers to supervise on behalf of the employer and so forth.

[94] See, generally, Van der Puil and Van Weele (n 76) 147 par 8.5; and Ashworth (n 53) 60. For examples, see the list of JCT contracts in Griffiths (n 34) 3-4; and Ashworth (n 53) 62-68 and 71-72. See further Finsen (n 17) 43-47 with reference to the many forms released by the JBCC.

[95] Regarding the use of standard-form guarantees in the construction industry, see par 4.2 and 8.1.3 below.

2.6.2 United Kingdom: JCT and NEC 3

2.6.2.1 JCT

The Joint Contracts Tribunal (JCT) provides various standard-form contracts for the construction industry, which are widely used in the United Kingdom.[96] Among the JCT contract family, the one for minor works "Minor Works Building Contract" has proved to be the most popular.[97] The JCT stems from the Royal Institute of British Architects (RIBA) founded in 1931. From 1977 onwards the contract forms developed by it bore the JCT's name.[98] The tribunal consist of several members who are all "representative bodies of various commercial interests in the building industry",[99] ensuring the unbiased and objective compilation of rules for construction contracts.

One of the latest major revisions of the JCT conditions was completed in 2011. The revision was deemed necessary *inter alia* to incorporate changes to give effect to the Local Democracy, Economic Development and Construction Act 2009,[100] while retaining the "policy of continuity"[101] from which the many users of the JCT contracts benefit. The JCT forms have been praised for their clear language and their contribution to legal certainty in the past. Hibberd puts it as follows:

> "Clarity and certainty are virtues in a contract and facilitate problem resolution rather than creating or frustrating the process. Relatively few of the vast number of JCT contracts used ever become the subject of legal proceedings. Where they do, it is frequently a user amendment to the contract that becomes the focus of the dispute."[102]

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[96] Goldsmith and Gould "United Kingdom" in Hernandez-Garcia *Construction and Infrastructure Disputes* (2013) 337 339 par 2.1; Bailey (n 5) 119; Uff (n 5) 342; Chappell *The JCT Design and Build Contract 2005* (2007) preface to the third edition; Hök "Risiken in Bauverträgen und ihre Handhabung - eine rechtsvergleichende Betrachtung" 2009 *Zeitschrift für deutsches und internationales Bau- und Vergaberecht* 515 518; and Hackett, Robinson and Statham (n 45) 95.

[97] Chappell (n 34) x.

[98] Hibberd (n 69) 1; and Ndekugri and Rycroft (n 19) 3. See also Bunni (n 40) 3.

[99] Ndekugri and Rycroft (n 19) 2-3.

[100] Chappell *Understanding JCT Standard Building Contracts* (2012) 1.

[101] Furst and Ramsey (n 36) 806 par 20-005.

[102] Hibberd (n 69) 3.

It would appear that the recent revisions[103] of the JCT forms have contributed much towards the fostering of clarity and certainty.[104] The most recent edition of the JCT forms was released in 2016.

2.6.2.2 NEC 3

Another popular group of standard-form contracts in the United Kingdom[105] is the "New Engineering and Construction Contract" (NEC 3), which is published by the Institute of Civil Engineers.[106] After the release of "consultative editions" in 1991,[107] the Institute issued the first regular edition in 1993, only to change the name from "New Engineering Contract" to "New Engineering and Construction Contract" two years later.[108]

The latest version of the NEC 3 contracts was made available in 2013. The NEC 3 contracts offer so-called core clauses, which then can be supplemented by additional provisions to make the contract most suitable for the construction project concerned.[109] The NEC 3 standard forms have been drafted along three objectives, namely flexibility,[110] simplification of language[111] and also an aspiration to "provide greater stimulus to good

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[103] On the revisions finalised by 2009, see Frame "New revision to standard forms issued by JCT" 2009 *Construction Law International* 3.

[104] Note the harsh criticism towards the earlier editions of JCT contracts by Lavers and Bick "Construction industry reform in the United Kingdom" 1995 *The Construction Lawyer* 35 37.

[105] Furst and Ramsey (n 36) 1249 par 22-002 list several other jurisdictions in which the NEC 3 contracts are applied, for instance South Africa and parts of the Middle East.

[106] Fergusson "NEC3 compared and contrasted with FIDIC" in Forward *NEC3 Compared and Contrasted* (2015) 95; Griffiths (n 34) 2; and Eggelston *The NEC 3 Engineering and Construction Contract* (2006) 1.

[107] Furst and Ramsey (n 36) 1075; and Eggelston (n 106) 1.

[108] Chappell *Building Contract Claims* (2011) 418.

[109] Goud "NEC3: construction contract of the future?" (presentation at the Society of Construction Law conference, Singapore February 2007) 3; Griffiths (n 34) 2; Uff (n 5) 359; and Chan Chuen Fye and Gunawansa (n 74) 453 (who describe such drafting technique as an "evolving feature in standard forms of building contract used in the construction industry").

[110] Fergusson (n 106) 100, who elaborates on the numerous available optional clauses within the structure of the NEC3.

[111] See Fergusson (n 106) 100 ("NEC3/ECC is written in simple language and narrative form, intended to be easily understood by people whose first language is not English, and was designed to be easily translated into other languages").

project management".[112] They have been described with approval as a "more simplified, standardised and user-friendly form of contract documentation".[113]

There has nevertheless been some negative criticism: Chappell[114] remarked that the numbering system of the NEC 3 (which was established in 2006) is "quite strange", whereas Uff[115] considers it to be "logical but unconventional". The adoption of the present tense and the original style of writing has also been frowned upon:

> "Some perceived shortcomings are that the syntax and grammar is not good. This is partly because the present tense is used almost exclusively even when one would normally expect to see past or future tenses. The form is supposed to be a model of simple English, but sticking almost exclusively to one tense does not assist comprehension. That leads to ambiguity and a lack of certainty."[116]

On the other hand, the Institute of Civil Engineers supplied "officially published guidance notes, flow charts and an advisory document entitled NEC 3 Procurement and Contract Strategies"[117] to assist the parties opting for the NEC 3 forms.[118] Overall, and despite the aforementioned criticism, the NEC 3 contract suit has been a "remarkable success story".[119] It is used today in many countries outside of the United Kingdom, including South Africa.[120] The NEC 3 has replaced standard-form contracts supported and supervised by the ICE.[121] It was probably the expanding use of the NEC 3 standard

[112] Eggelston (n 106) 2.

[113] Griffiths (n 34) 2. Note also the findings in Rameezdeen and Rodrigo (n 86) 9 ("better language structure and readability").

[114] Chappell (n 108) 419.

[115] Uff (n 5) 359.

[116] Chappell (n 108) 418. For more lenient views, however, see Furst and Ramsey (n 36) 1249 par 22-002 ("somewhat unconventional style"); Uff (n 5) 359-360 ("unconventional drafting"); and Goud (n 109) 28 ("clearly a departure from the traditional approach to construction contract drafting").

[117] Eggelston (n 106) 1 (italics omitted). See also Furst and Ramsey (n 36) 1255 par 22-008.

[118] But note the remark of Eggelston (n 106) 4.

[119] Eggelston (n 106) 2.

[120] Klee (n 36) 310 par 13.3; and Baird (n 89) 116 (contains an interesting and recent list of construction projects in South Africa which utilised the NEC3 contracts). See further Furst and Ramsey (n 36) 1249 par 22-002. Apparently, the international application of the NEC contracts was originally intended (see Broome and Hayes (n 90) 255).

[121] The so-called "ICE Conditions of Contract" (Eggelston (n 106) 2).

form that led the ICE to the decision[122] not to update these, despite their widespread use in the construction industry in the United Kingdom.[123]

2.6.3 Germany: VOB

In Germany the most accepted standard-form contract is the "Vergabe- und Vertragsordnung für Bauleistungen (VOB)".[124] It is issued by the "Deutscher Vergabe- und Vertragsausschuss für Bauleistungen" and is divided into three parts: the "VOB/A (Allgemeine Bestimmungen für die Vergabe von Bauleistungen)"; "VOB/B (Allgemeine Vertragsbedingungen für die Ausführung von Bauleistungen)"; and "VOB/C (Allgemeine Technische Vertragsbedingungen für Bauleistungen)".[125] As suggested by their names the three different parts of the VOB serve distinct purposes. Tendering and procurement processes, especially important for the public sector, are regulated by the VOB/A;[126] the *VOB/B* sets the general conditions and scope of the actual work on the construction project in a wider sense for the parties; and the VOB/C gives comprehensive technical guidelines as to how specific types of works and services must be rendered, for instance drilling (DIN 18301), painting (DIN 18363) or labour relating to scaffolding (DIN 18451).

For some period of time there has been uncertainty about the VOB/B's legal classification and pursuant to it the question of judicial authority to review and declare illegal some of its provisions in accordance with the relevant sections of the *Bürgerliches*

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[122] See, for instance, Bailey (n 5) 122 par 3.13; and Furst and Ramsey (n 36) 1076 par 21-002.

[123] See Haswell and Da Silva *Civil Engineering Contracts* (1982) 49 ("In the United Kingdom the form used is invariably the Institution of Civil Engineers Conditions of Contract").

[124] Hök (n 96) 518; Henssler (n 81) paragraph 631 par 112; and Martinek (n 74) 1111 par 14. Wallace (n 16) 374 par 23-18 estimated that 80 per cent of all constructions in then-West-Germany utilised this standard-form contract.

[125] Jansen and Seibel *VOB Verdingungsordnung für Bauleistungen Teil B* (2016) intro par 2-4; and Henssler (n 81) paragraph 631 par 130-132**.** "Allgemeine Bestimmungen für die Vergabe von Bauleistungen" may be translated as "General provisions for the award of construction services"; "Allgemeine Vertragsbedingungen für die Ausführung von Bauleistungen" may be translated as "general terms and conditions for the execution of construction services" and "Allgemeine Technische Vertragsbedingungen für Bauleistungen" as "general technical terms and conditions for construction services" (my translations).

[126] Vygen and Joussen *Bauvertragsrecht nach VOB und BGB* (2013) 74 *et seq*; and Kulick *Auslandsbau* (2010) 85-90.

Gesetzbuch (*BGB*) – the German Civil Code.[127] However, it is now established under German law that the VOB/B is in fact subject to the statutory requirements for the use of standard terms and conditions[128] and, consequently, to a certain extent, judicial scrutiny.[129] Due to the many opportunities for German courts to interpret and rule on the VOB conditions, and the vast body of legal scholarship, there is much material available in this regard which has contributed significantly to legal certainty and understanding.[130] The 2012 update restructured the VOB/A and implemented guidelines for the tendering process, mainly in respect of procurement for national security and defence purposes.[131] It brought in stipulations relating to due-dates of payment in order to comply with European Union law.[132] Part C of the VOB is constantly being updated and revised in order to meet new developments that represent the expectations and standards of the industry.[133] This is clearly evident also in the 2012 edition.[134] The latest version of the VOB is the 2016 edition which, *inter alia*, implemented further European Union directives.

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[127] See BGH *BGHZ* 55, 198, 200; BGH (n 86) 139; BGH *NZBau* 2008, 640; Vygen and Joussen (n 126) 153 *et seq*; and Martinek (n 74) 900 par 24-25.

[128] Bassenge (n 75) intro paragraph 631 par 5; Jacoby and Peters (n 61) intro paragraph 631 par 94; and Martinek (n 74) 1112-1113 par 24. For an interesting analysis of the "contra proferentem" rule in English law in respect of standard-form contracts for construction, regard may be had to Netto, Christudason and Kor (n 86) 387 *et seq*.

[129] In this regard, see Bamberger and Roth *Beck'scher Online-Kommentar BGB* (2016) paragraph 307 par 145-152; Diehr *VOB/B 2012 Kommentar für die Baupraxis* (2012) 1-5; and Büchting and Heussen *Beck'sches Rechtsanwalts-Handbuch* (2011) § 23 Privates Baurecht par 3-5.

[130] See Griffiths (n 34) 215; Jellinger (n 53) 212 par 11.3; and Bubshait and Almohawis "Evaluating the general conditions of a construction contract" 1994 *International Journal of Project Management* 133, though obviously not referring to the *VOB* in particular, but rather standard-form construction contracts in general.

[131] Kapellmann and Messerschmidt *VOB Teile A und B* (2013) Teil 1 Teil A intro par 25 and 28; and Ganten, Jansen and Voit (n 81) intro par 32. For the recent developments of the *VOB/A* within the last years see Mestwerdt *VOB/A 2012 Kommentar für die Bau- und Vergabepraxis* (2013) 3-5.

[132] Kapellmann and Messerschmidt (n 131) Teil 3 Teil B intro par 13c.

[133] Englert, Katzenbach and Motzke *Beck'scher VOB-Kommentar Vergabe- und Vertragsordnung für Bauleistungen Teil C* (2014) intro Die *VOB* Teil C in der Baupraxis.

[134] Ganten, Jansen and Voit (n 81) intro par 32.

2.6.4 South Africa: JBCC and GCC

2.6.4.1 JBCC

In South Africa different standard-form contracts are currently in use,[135] the dominant ones being the "Principal Building Agreement (PBA)", promulgated by the "Joint Building Contracts Committee (JBCC)", and the "General Conditions of Contract (GCC)", endorsed by the "South African Institute of Civil Engineering".[136] While the JBCC's contract forms are popular for the construction of buildings particularly in the private and municipal sector,[137] the GCC's documents are used mainly for civil engineering projects.[138] The JBCC's agreements originate from standard forms drafted by the Royal Institute of British Architects, and were amended and updated several times over the decades by the committee.[139] The JBCC contracts have been described as "a product of many years of industry-wide debate, consideration and ultimately consensus. All of the role players in the construction industry know its ambit and terms […]."[140] According to Van Deventer the contracts by the JBCC comprise a "set of documents which represents the norm of the construction industry", negotiated by "representatives of all the various interest groups who participate in the construction industry in South Africa".[141] Writing in 1993, this fact persuaded him to conclude that "these documents will be very widely used within the industry, and will become the norm of industry usage".[142] More than twenty years later, and with an increasing demand for the JBCC

[135] Maritz "Doubts raised on the validity of construction and payment guarantees" 2011 *Acta Structilia* 1 3; and Baird (n 89) 116; and Hugo "Bank guarantees" in Sharrock *The Law of Banking and Payment in South Africa* (2016) 437 439-440.

[136] See also Hugo "Protecting the lifeblood of commerce: a critical assessment of recent judgments of the South African supreme court of appeal relating to demand guarantees" 2014 *TSAR* 661 662 *et seq*.

[137] Garner (n 89) 1; and Baird (n 89) 116.

[138] Hugo "Construction guarantees and the Supreme Court of Appeal (2010 – 2013)" in Visser and Pretorius *Essays in Honour of Frans Malan* (2014) 159 165; and Garner (n 89) 1.

[139] Finsen (n 17) 41-43; and Brink and Botha (n 89) 2-4. See generally also Vosloo *The Determination of Pertinent Contract Document Requirements for Landscape Projects in South Africa* (2008 thesis Pretoria) 36 *et seq*.

[140] *Hyde Construction CC v Blue Cloud Investments 40 (Pty) Ltd* [2012] JOL 28470 (WCC) per Gamble J at 34.

[141] Van Deventer (n 3) 155 par 5.28. See also Garner (n 89) 13-14.

[142] Van Deventer (n 3) 155 par 5.28.

PBA,[143] this has proved to be a correct observation.[144] The most recent JBCC PBA version is the edition 6.1, released in March 2014. Reportedly, there have been initiatives to extend the application of the JBCC contracts to projects outside South Africa, but apparently without much success, "probably due to innate conservatism and lack of active promotion of the documents rather than that they have been tried and found wanting".[145] Unfortunately, there is a noticeable lack of commentary and legal writing on the JBCC in general,[146] leaving clauses unexplained and particular issues unresolved. There is, however, some South African case law relating to JBCC contracts, which has contributed to a more uniform interpretation and legal certainty in this regard.[147]

2.6.4.2 GCC

As noted above, the GCC contract is more popular for civil engineering undertakings other than buildings in South Africa.[148] The GCC promise to "set out fair, equitable, efficient, economic and transparent contract administration procedures, and the allocation of risks"[149] while resorting to "plain language which makes it easy for all people to understand the provisions".[150] It is reported to have incorporated a "stronger emphasis on

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[143] Cumberlege, Buys and Vosloo (n 89) 101.

[144] Note the observations in Hugo (n 136) 662; Richards, Bowen, Root and Akintoye (n 85) 475-476 ("Its wide acceptance has readily made the document an industry standard for construction procurement in South Africa"); and Hök *Handbuch des internationalen und ausländischen Baurechts* (2012) 1070 par 15.

[145] Finsen (n 17) 48-49. See also "JBCC 2000 – who will be the judge?" February 2001 *The Civil Engineering and Building Contractor* 12 (author unknown). However, note also the different, albeit cautious, analysis by Maritz (n 135) 24.

[146] See the remarks by Beyers "Book review McKenzie's Law of Building and Engineering Contracts and Arbitration" 2010 *Stellenbosch Law Review* 207 209. Finsen (n 17) and Garner's comprehensive commentary on the JBCC 2014 forms of contract (n 89), therefore, are some of only few exceptions.

[147] Consider the *dictum* by Gamble J "it is important that there be consistency in its [the JBCC's] application" – my insertion) in *Hyde Construction CC v Blue Cloud Investments 40 (Pty) Ltd (n 140)* at 34.

[148] Hugo (n 138) 165; Binnington "GCC 2010?" 2010 *The Civil Engineering Contractor* 50; and Croeser *How Effective are Standard Form Construction Contracts in Dealing with Contract Variations and Contractors' Claims* (2009 thesis Pretoria) 2 and 7. Generally, for the GCC, see also Vosloo (n 139) 47 *et seq*.

[149] South African Institution of Civil Engineering SAICE (n 59) 3.

[150] South African Institution of Civil Engineering SAICE (n 59) 9 par 6.1.3.

clearer allocation of responsibilities of the parties, allocation of risks to the party best able to manage it, and for the parties to consult more closely on issues where a decision or ruling by the engineer is required".[151] The most recent edition of the GCC dates from 2015.

Despite its widespread application in South Africa, unfortunately the GCC has also not attracted much legal scholarship to date. This leaves the important task of its development and evaluation mainly to the South African courts.[152] The JBCC and GCC contracts have both been approved and recommended for government procurement undertakings.[153]

2.6.5. International construction contracts: FIDIC

"The International Federation of Consulting Engineers (FIDIC)"[154] is an "international Federation of duly elected associations of consulting engineers representing the profession in their respective countries",[155] and has published several standard-form contracts since 1957.[156] On an international level, these FIDIC contracts are of considerable importance,[157] and scholars have observed that they "are nowadays the most widely used sample forms of contracts for construction projects".[158] They range from the

[151] Binnington (n 148) 50.

[152] See South African Institution of Civil Engineering SAICE (n 59) 1-2.

[153] Binnington (n 148) 50; and Vosloo (n 139) 4-5 and 30-31, 33-34. Recommendations and requirements for public bodies in South Africa are set by the "Construction Industry Development Board" (CIDB). Apart from the JBCC and GCC, the other two approved standard-form contracts are the FIDIC and the NEC contracts.

[154] The acronym FIDIC is derived from the French name *Fédération Internationale Des Ingénieurs-Conseils*.

[155] Bunni (n 40) 6.

[156] Roquette and Otto *Vertragsbuch Privates Baurecht* (2011) FIDIC-Standardbedingungen par 2; Wade (n 86) 5; and Seppala "The new FIDIC international civil engineering subcontract" 1995 *The Construction Lawyer* 25.

[157] Weselik and Hamerl (n 89) 50 par 1; Beale (n 18) 719-720 par 37-021; and Klee (n 36) 267 par 12.3 as well as 305 par 13.1. Robinson even goes as far as stating that the FIDIC contracts "have for many years had no rival as the standard form of choice for use in the international construction industry" (*A Contractor's Guide to the FIDIC Conditions of Contract* (2011) v (preface)). Similarly, according to Charrett (n 13) 82-83, the FIDIC contracts "are probably the most widely used around the world for international construction".

[158] Klee (n 36) 266 par 12.1.

"Conditions of Contract for Construction of Building or Engineering Works", arguably the most important one, to the "Short Form of Contract for Building and Engineering Works of Relatively Small Value".[159] The different FIDIC contracts are usually referred to by colours, for instance the red book, the silver book and so on.[160] Most importantly, all the contract documents are intended and actually used mainly within an international construction environment.[161] As they are printed in different languages,[162] accessibility for the international market is increased. Thus, it is not surprising that the World Bank, the European Investment Bank and the European Union occasionally endorse or even strictly require the use of the FIDIC contracts for their projects, or borrow extensively from the FIDIC contracts to formulate their own conditions.[163] The use of the FIDIC contracts may encourage international parties to be less concerned about their unfamiliarity with foreign laws and jurisdictions,[164] and to trust in FIDIC's "international character",[165] with its unbiased risk distribution between employer and contractor.[166] Furthermore, it has been observed that the FIDIC contracts are often adopted by parties

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[159] Uff (n 5) 403.

[160] Weselik and Hamerl (n 89) 50-53; Furst and Ramsey (n 36) 1256 par 22-009; Roquette and Otto (n 156) FIDIC-Standardbedingungen par 2; Bailey (n 5) 125-127 par 3.17. Due to the colour codes, the FIDIC contracts are sometimes called the "rainbow suite" or "rainbow contracts" (Robinson (n 157) 166; and Wade (n 86) 5 and 22).

[161] Van Deventer (n 3) 157 par 5.32; Fergusson (n 106) 96; Furst and Ramsey (n 36) 1256 par 22-009; and Charrett (n 13) 82-83. In regard to standard-form contracts and international construction see also the remarks of Bunni (n 40) 6 relating to the early "ACE Form"; and Rubin, Fairweather and Guy (n 36) 24-25 and 38.

[162] Ashworth (n 53) 69.

[163] Hök (n 144) 506 *et seq*; Klee (n 36) 91 par 5.3.2 and 92 par 5.3.4; Roquette and Otto (n 156) FIDIC-Standardbedingungen par 40; Seppala (n 156) 25; Fawzy and El-Adaway "Contract administration guidelines for U.S. contractors working under World Bank-funded projects" 2012 *Journal of Legal Affairs and Dispute Resolution in Engineering and Construction* 40; and Robinson (n 157) 166. See also Ndekugri "Network of experts on FIDIC contracts" 2004 *The International Construction Law Review* 482.

[164] Bailey (n 5) 128 par 3.18. Note, however, the criticism of Seppala (n 156) 26 concerning the perceived bias of the FIDIC red book contract in regard to format and terminology in favour of the common law. See, however, Charrett (n 13) 83 who is less concerned in this regard.

[165] Bailey (n 5) 125 par 3.16.

[166] Kehlenbach "Die neuen FIDIC-Musterbauverträge" 1999 *Zeitschrift für deutsches und internationales Bau- und Vergaberecht* 291 292 and 297; Seppala (n 156) 25; Hök "FIDIC Verträge im (inter-)nationalen Anlagenbau – eine Rundschau" 2012 *Zeitschrift für deutsches und internationales Bau- und Vergaberecht* 731 735; and Osinski (n 85) 1. Note, however, her considerably less enthusiastic comment concerning the 1999 editions of FIDIC contracts at 2.

for domestic projects, especially in jurisdictions where there are no local standard-form contracts for construction.[167] Klee concludes, that "[t]hese days, FIDIC forms (as a standardized law applicable to construction projects) are without doubt part of *lex mercatoria*".[168]

2.7 General concluding remarks and analysis

This overview of selected facets of the construction context has introduced the important parties in construction, the prevalent terminology and the contracting, procurement and tendering process. The introduction to the available standard-form contracts has indicated that many such contracts are used in construction.[169] Scholars have raised concerns about this fact and have observed, that this "plethora" has "bedeviled" the construction industry.[170] Griffiths explains, that

> "[t]he drawback of having such a multiplicity of contract forms are, firstly, the difficulty of becoming familiar with the critical obligations and liabilities of each form, and secondly, the more onerous task of identifying the subtle variations of each form. [...] As a result, it is possible for parties to make administrative errors because they are not familiar with the standard form of contract being used."[171]

Notwithstanding such criticism – as justified as it may be – it is important to acknowledge the major role which the standard-form contracts play in the construction industry. It is inconceivable to imagine the construction industry functioning efficiently without the use of such contracts.

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[167] See Bailey (n 5) 128 par 3.18 with supportive references in n 94. In Baird (n 89) 116, the author lists several South African and Southern African construction and engineering projects which opted for FIDIC contracts. Additionally, it is reported that amendments to the FIDIC forms led to disputes and arbitration.

[168] Klee (n 36) 94 par 5.5 (my alteration).

[169] For a list of further standard-form contracts see Bailey (n 5) 122-125, and 128-131.

[170] Lavers and Bick (n 104) 37. Even though their criticism was placed in the context of the construction industry in the United Kingdom, it is arguably universally valid. See also the remarks of Ashworth (n 53) 59.

[171] Griffiths (n 34) 4 (my omission and alteration). Despite his comments being made in response to the various JCT contracts in particular, it is submitted that his observations are equally relevant regarding the vast numbers of standard-form construction contracts in general.

Chapter Three: Demand guarantees in general legal perspective

3.1 Introduction: the need for security

International business transactions bring about an increased risk due to the cross-border component, requiring the concerned parties to have regard to issues like security for performance, enforcement of debts, judgments and arbitration awards across borders, the unfamiliarity with a foreign legal system, jurisdictional disputes, political interference and the complicated procedures for ascertaining the financial standing and capability of business partners, to name but a few.[1] But one does not necessarily need to cross borders to encounter uncertainties of such importance. "Large construction projects provide considerable scope for disputes of various kinds to arise, both in the course of executing the works and after the works have been completed", as Nugent JA observed in *Radon Projects (Pty) Ltd v N V Properties (Pty) Ltd*.[2] Similarly Reed states that "[c]onstruction and engineering projects, whether land-based, marine or aviation, are inherently risky".[3] Therefore, entirely domestic transactions can already involve a number of risks and potential pitfalls. Thus, Barru warned: "Major construction projects are complex and high-risk endeavors. […] Complexity is inherent in construction."[4] He then continued to identify a large number of different types of risks in the context of construction, which are well worth quoting:

> "First, there are the ordinary and significant risks of design errors and construction defects. In addition, there are: (1) physical risks (severe weather, earthquakes, floods, tornados, tsunamis, heat, cold, altitude, and humidity); (2) labor risks (strikes, work slowdowns, riots); (3) human risks (corruption, vandalism, theft, job site safety, and disease); (4) design and technology risks (using new and untried technology, materials, or processes); (5) site risks (latent surface conditions, environmental contaminations, endangered or protected species, archeological or anthropological discoveries); (6) logistics difficulties (congested urban areas, remote isolated sites); (7) supplier and transportation risks (material shortages and delivery delays); (8) regulatory risks (complex government permitting and approval processes); (9) financial risks (war, terrorism, government intervention, such as wage and price controls). Other risks associated with foreign projects include working in a multicultural environment, language barriers, visa and work permit requirements, currency exchange risks,

[1] See Kulick *Auslandsbau* (2010) 213-214 with specific reference to construction; Jahrmann *Außenhandel* (2010) 289 *et seq*; Häberle *Handbuch für Kaufrecht, Rechtsdurchsetzung und Zahlungssicherung im Außenhandel* (2002) 611-628; Kaya *Die Grenzen der Einwendungen der Bank gegen den Zahlungsanspruch des Begünstigten aus einem unwiderruflichen Akkreditiv* (1999) 15; Heidbüchel *Das UNCITRAL-Übereinkommen über unabhängige Garantien und Standby Letters of Credit* (1999) 55; Richter *Standby Letter of Credit* (1990) 51; and Hugo *The Law Relating to Documentary Credits from a South African Perspective with Special Reference to the Legal Position of the Issuing and Confirming Banks* (1996 thesis Stellenbosch) 2-3 par 1 2.

[2] 2013 (6) SA 345 (SCA) par 1 (Leach and Pillay JJA, and Erasmus and Saldulker AJJA concurring).

[3] Reed *Construction All Risk Insurance* (2014) 1 par 1-001 (alteration by me).

[4] Barru "How to guarantee contractor performance on international construction projects: comparing surety bonds with bank guarantees and standby letters of credit" 2005 *The George Washington International Law Review* 51 (omission and insertion by me).

> international double taxation, barriers to repatriation of profit, and legal disputes arising in multiple jurisdictions."[5]

Therefore, especially in connection with expensive or expansive construction projects or long-term service and supply contracts, the need for security is evident. According to their requirements, business priorities and – paramount – their respective bargaining power, each party to such a contractual relationship may choose from a variety of different means and contracts of security.[6] In this regard demand guarantees – the main instrument of interest in this study – were described as an "integral part of construction contracts",[7] highlighting their importance to international trade and the industry. This chapter focusses primarily on independent, abstract demand guarantees and documentary letters of credit, both of which establish primary, autonomous obligations, as opposed to mere so-called secondary, accessory obligations (suretyship, traditional guarantee, and German "Bürgschaft").[8] However, in order to emphasise the abstract and independent nature of the obligations under scrutiny (demand guarantees and letters of credit), regard is also to be had to the differences between primary, autonomous undertakings on the one hand, and secondary, conditional obligations on the other hand. Overall, the main focus of attention is placed on the law in England, South Africa and Germany, while taking into account occasionally also legal development, scholarly commentaries and case law from other jurisdiction such as Australia, the United States, Malaysia and Singapore. Whenever appropriate, regard will be had to international frameworks as well as standard-form contracts and standard-form guarantees.

3.2 Legal framework: the laws and conventions governing demand guarantees

Unfortunately,[9] the area of independent security and payment instruments like demand guarantees and letters of credit is insufficiently covered by (domestic) statutory provisions

[5] Barru (n 4) 52 (omission of footnote by me).

[6] For examples of different means and contracts of security in the construction industry, see par 4.5 *et seq* below.

[7] Wong "Recent developments on demand bonds and guarantees in England and Australia" 2012 *The International Construction Review* 51.

[8] See also par 4.5.2 below.

[9] But note the remarks by Apathy, Iro and Koziol *Österreichisches Bankvertragsrecht Band V: Akkreditiv und Garantie* (2009) 13 par 1/15 (who make the point that the "internationality" of letters of credit may discourage domestic legislation, because detailed rules are needed that are internationally understood and uniformly applied: "Zum anderen hat wohl die Internationalität dieses Zahlungsinstruments nationale gesetzgeberische Tätigkeiten gar nicht wünschenswert erscheinen lassen. Denn das Akkreditivgeschäft

throughout the world.[10] As Bertrams reported, "[i]n most countries, no specific legislation exists on independent guarantees, while only a very few countries have some statutory provisions of a general nature".[11] Thus, the legal frameworks within which demand guarantees and letters of credit operate are often not adequately defined by statutory laws.[12]

As a consequence of the absence of reliable rules and regulations, many issuers of demand guarantees and letters of credit make them subject to established international guidelines and frameworks.[13] Especially the ICC Uniform Customs and Practice of Documentary Credits (UCP),[14] now in its latest edition UCP 600,[15] enjoy widespread use among merchants and issuing banks in the field of letters of credit. This is evidenced in

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verlangt detaillierte Regelungen, die international in gleicher Weise verstanden und angewendet werden" – footnotes omitted by me).

[10] De Ly "The UN Convention on independent guarantees and stand-by letters of credit" 1999 *The International Lawyer* 831 833-834; Gao "The fraud rule under the UN convention on independent guarantees and standby letters of credit: A significant contribution from an international perspective" 2010 *George Mason Journal of International Commercial Law* 48; Langenbucher, Bliesener and Spindler *Bankrechts-Kommentar* (2016) 1819 par 5; Claussen *Bank- und Börsenrecht* (2008) 285 par 142; Broekhuizen "Suretyships and independent guarantees under Dutch law" in Drobnig, Sagel-Grande and Snijders *Neuere Entwicklungen im Recht der persönlichen Kreditsicherheiten in Deutschland und in den Niederlanden* (2003) 91 94; Spaini *Die Bankgarantie und ihre Erscheinungsformen bei Bauarbeiten* (2000) 301 par 6; Heidbüchel (n 1) 56 par 2 and 73; Lienesch *Internationale Bankgarantien und die UN-Konvention über unabhängige Garantien und Stand-by Letters of Credit* (1999) 1 and 7 par IV; Rowe *Letters of Credit* (1997) 23; and Pierce *Demand Guarantees in International Trade* (1993) 23. Note, however, the contrary claim – or so it seems – in Van Niekerk and Schulze *The South African Law of International Trade: Selected Topics* (2016) 248 par 3.4.1 (second sentence). Furthermore, the "Organisation for the Harmonisation of Business Law in Africa" (OHADA) adopted a new "Uniform Act on (Organising) Securities" in 2010. The act contains statutory provisions relating to, *inter alia*, demand guarantees (Articles 39-49), which apply in all 17 member states since May 2011.

[11] Bertrams *Bank Guarantees in International Trade* (2013) 33 par 2-15/17 (alteration and footnote omitted by me). For an instructive (but dated) overview in this regard, Schütze and Fontane *Documentary Credit Law throughout the World* (2001) 45 *et seq*.

[12] Bertrams (n 11) 33-34 par 2-15/17; Drobnig "Guarantee, independent" in Basedow, Hopt, Zimmermann and Stier *The Max Planck Encyclopedia of European Private Law Volume I* (2012) 806 par 2 and 808 par 4; Ryder, Griffiths and Singh *Commercial Law Principles and Policy* (2012) 218; and Kümpel and Wittig *Bank- und Kapitalmarktrecht* (2011) 1691 par 13.3 (for demand guarantees) and 1731 par 13.104 (for letters of credit). See further Drobnig "Die richterliche Neuregelung des Bürgschaftsrechts in Deutschland – Einleitender Überblick" in Drobnig, Sagel-Grande and Snijders *Neuere Entwicklungen im Recht der persönlichen Kreditsicherheiten in Deutschland und in den Niederlanden* (2003) 1 10 for the German legislature's deliberate decision not to enact specific provisions for demand guarantees. Hök *Handbuch des internationalen und ausländischen Baurechts* (2012) 557 par 7 called the lack of legislative initiatives regarding bank guarantees "[e]igentümlich" (alteration by me).

[13] Apathy, Iro and Koziol (n 9) 16 par 1/19.

[14] In this thesis referred to as UCP or UCP 600.

[15] The most recent version, the UCP 600, was approved in 2006 by the ICC Banking Commission, and became operative as from July 2007. See Malek and Quest *Jack: Documentary Credits* (2009) 11 par 1.21. For an account of the history of the UCP, see Hugo "Letters of credit and demand guarantees: a tale of two sets of rules of the International Chamber of Commerce" 2017 *TSAR* 1 6 *et seq*.

statements by scholars, who claim that today almost all letters-of-credit transactions are subject to the UCP.[16] Hugo stated that "[t]he UCP is without doubt the most important source to be consulted in documentary-credit practice".[17] Regarding the need for and the advantages of the almost universal application of the UCP, *Jack: Documentary Credits* remarks as follows:

> "The convenience 'if not the necessity' of an international code governing the operation of documentary credits and providing uniformity is obvious given the internationality of credit transactions. By being incorporated into the contracts which come into being in connection with credits, a code can provide a uniformity in the rights and obligations to which those contracts give rise. It can encourage a uniformity of banking practice in relation to credits. It can reduce the differences which might otherwise emerge as a result of differences in national laws relating to credits."[18]

Due to the success of the UCP across national borders and continents, the business of letters of credit has established and maintained a large degree of certainty through uniform application in many jurisdictions.[19] This, however, may not be said in regard to demand guarantees, where – until now – no international convention or regulatory codification has achieved acceptance comparable to that of the UCP 600.[20] Rather, several different frameworks compete for application (by contractual incorporation or the ratification of a convention) by the parties to govern demand-guarantee transactions.[21] The most important of these are the "Uniform Rules for Demand Guarantees (URDG 758)",[22] the "International Standby Practices (ISP98)",[23] and the "UNCITRAL Convention on Independent Guarantees

[16] McKendrick *Goode on Commercial Law* (2010) 1055; Hugo "Payment in and financing of international sale transactions" in Sharrock *The Law of Banking and Payment in South* Africa (2016) 394 403 par 9.5.1; and Van Niekerk and Schulze (n 10) 249 par 3.4.2 ("currently incorporated in the vast majority of letters of credit issued worldwide").

[17] Hugo (n 1) 128 par 3 10 1.

[18] Malek and Quest (n 15) 10 par 1.20.

[19] Nevertheless, several important issues are still debated today, with courts and arbitral tribunals given the task of reconciling and harmonising the many divergent decisions, so as to lessen the impact of tactical forum shopping and choice-of-forum clauses. Also, note the remarks in regard to textual uniformity as opposed to uniformity in application (par 3.2.4 below).

[20] Enonchong *The Independence Principle of Letters of Credit and Demand Guarantees* (2011) 39 par 3.32.

[21] Willmann *Die Bankgarantie im Bauwesen* (2013) 83, in a definite statement, declared all international attempts for a harmonisation of the law of demand guarantees a failure ("können im Großen und Ganzen als gescheitert bezeichnet werden").

[22] See par 3.2.1 below.

[23] See par 3.2.2 below.

and Stand-by Letters of Credit (UNCITRAL Convention)".[24] These three sets of rules are investigated further below.

3.2.1 Uniform Rules for Demand Guarantees (URDG)

The URDG were first published in 1992 (the so-called URDG 458) by the International Chamber of Commerce (ICC).[25] Stemming from the preceding "Uniform Rules for Contract Guarantees" (URCG 325), the URDG are the product of a considerable redrafting process after the URCG 325 failed to satisfy expectations by business people in the field of demand guarantees.[26] Writing in 2002, Gao recounted:

> "[T]he URCG has rarely been accepted or used since its publication. One reason is a conceptual problem in that the URCG has not made clear that it is confined to independent guarantees and does not apply to accessory guarantees."[27]

Especially the need to attach a favourable court decision or an award by an arbitral tribunal to each claim under the guarantee was seen as the main reason for the lack of success of the URCG 325.[28] The URDG 458, subsequently, "struck a more reasonable balance between protection of the account party and allowing the beneficiary to have a security that is promptly and readily realizable".[29] In addition, the "prevention of fraud" was recognised as a main objective in the URDG 458.[30] While abandoning the need for a judgment or arbitral award to attest to the soundness of the claim under a demand guarantee, the URDG 458 then introduced the requirement of a notice in writing stating the reason for the demand (typically the breach of contract).[31] Unfortunately, despite these considerable improvements towards a

[24] See par 3.2.3 below.

[25] Bertrams (n 11) 28 par 2-13.

[26] Graf von Westphalen and Zöchling-Jud *Die Bankgarantie im internationalen Handelsverkehr* (2014) 444-445 par 3-4; Enonchong (n 20) 39-40 par 3.33-3.34; and Häberle (n 1) 834.

[27] Gao *The Fraud Rule in the Law of Letters of Credit* (2002) 19 (alteration by me). For a further discussion of accessory, secondary guarantees as opposed to independent, demand guarantees see par 4.5.2 below.

[28] Enonchong (n 20) 40 par 3.33; Gao (n 27) 19; Heidbüchel (n 1) 60-61; Debattista "Performance bonds and letters of credit: a cracked mirror image" 1997 *Journal of Business Law* 289 296-297; Hugo (n 15) 15; and further Richter (n 1) 101 ("Die ERVG waren aber von Anfang an zum Scheitern verurteilt") and his general remarks at 101-102.

[29] Enonchong (n 20) 40 par 3.34.

[30] De Ly (n 10) 835.

[31] Art20 URDG 458. McKendrick (n 16) 1140-1141; Heidbüchel (n 1) 64-65; and Lienesch (n 10) 10. See also Graf von Westphalen "Die neuen einheitlichen Richtlinien für 'Demand Guarantees'" 1992 *Der Betrieb (DB)* 2017 2020-2021 for a critical assessment of the newly introduced prerequisite. He calls the

more accessible, business-orientated approach, as Bertrams states, the "URDG 458 have not gained wide and regular acceptance".[32]

In 2010, an updated text of the URDG came into effect under the acronym URDG 758.[33] "The new rules are intended to be clearer, more precise, more comprehensive, more balanced, and more innovative", as Enonchong[34] has put it. According to him, the "URDG 758 has been aligned in a number of respects with UCP 600. For example, it adopts the drafting style of UCP 600 by including provisions on definitions and interpretations".[35] Hence, it is reasonable to assume that the drafters of the new URDG 758 were hoping to increase the usefulness and popularity of the URDG by borrowing from the well-established UCP 600. Concerning the applicability of the URDG to demand guarantees, it is important to take note of the fact that the URDG "does not have the force of law".[36] As a result, parties[37] to a demand guarantee would have to make clear reference to the rules in order to have them incorporated into their contract.[38] Yet, despite the lack of default incorporation by law, scholars regard the URDG as influential and significant.[39] This was established by the positive confirmation from Bertrams: "While the URDG do not have the force of law, it may

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introduction of the requirement for a written demand, which also specifies the reason for the calling-up, the "centrepiece" (the original German at 2020 par 2 reads "Herzstück") of the reform.

[32] Bertrams (n 11) 28 par 2-13; similar also Hugo "Documentary credits and independent guarantees" 2004 *Annual Banking Law Update* 24 par 4 3; and Häberle (n 1) 834.

[33] Affaki and Goode *Guide to ICC Uniform Rules for Demand Guarantees URDG 758* (2011) offer a comprehensive commentary on the URDG 758, and provide a synopsis table juxtaposing the URDG 458/URDG 758 (at 24-29). Hereinafter, the Uniform Rules for Demand Guarantees are referred to as URDG or URDG 758.

[34] Enonchong (n 20) 40 par 3.36.

[35] Enonchong (n 20) 40 par 3.36. In fact, Gao (n 27) 20 had observed a similar trend already in respect of the earlier URDG 458 ("The text of the URDG is strongly influenced by the UCP").

[36] Enonchong (n 20) 41 par 3.38; similar also Davidson "Fraud and the UN Convention on Independent Guarantees and Standby Letters of Credit" 2010 *George Mason Journal of International Commercial Law* 25 26.

[37] In particular the applicant, after having been required to do so by the (future) beneficiary in the underlying contract, would have to request and instruct the guarantor accordingly in terms of the contract of mandate. Ultimately, it is the guarantor who holds the power to incorporate the URDG into the transaction by including a reference to the rules when issuing the instrument.

[38] Davis *Refund Guarantees* (2015) 8 par 2.32; and Affaki and Goode (n 33) 33 par 68. Unfortunately, in South Africa the URDG are seldom made applicable to demand guarantees. See Hugo "Construction guarantees and the Supreme Court of Appeal (2010 – 2013)" in Visser and Pretorius *Essays in Honour of Frans Malan* (2014) 159 160.

[39] Davidson (n 36) 27.

well be that, in view of their authoritative source and the way they have come to be adopted, they will affect developments in the law anyway."[40]

Furthermore, he went on to appreciate the URDG's readiness to consolidate and incorporate the varying interests the parties to a demand guarantee may have by observing that "[s]everal of its provisions can be seen as a reflection of a broad consensus among bankers, industry and all members of the guarantee community".[41] It remains to be seen whether the URDG 758 can overcome the current reluctance of the industry to favour one particular set of rules governing demand guarantees.[42] This issue is connected to the question whether standard-form contracts[43] for construction works are incorporating the URDG 758 for their standard construction-guarantee sections. In this regard, Kelly-Louw reported a few years ago that the URDG "has been accepted by the World Bank as the rules for its standard guarantees" but that, as yet, "South African banks are not generally issuing demand guarantees subject to the URDG".[44]

3.2.2 International Standby Practices (ISP98)

The ISP98 were devised by the Institute of International Banking Law and Practice in 1998 and subsequently endorsed by the International Chamber of Commerce.[45] These rules were drafted to be made applicable to the so called "standby letter of credit", an instrument which originated in the United States of America due to the prohibition in that country of issuing

[40] Bertrams (n 11) 29.

[41] Bertrams (n 11) 29 par 2-13 (alteration by me).

[42] Probably positive in such regard DCInsight "The insight interview: Georges Affaki – the new URDG 758: one year on" 2011 *DCInsight* October – November; Hugo "Bank guarantees" in Sharrock *The Law of Banking and Payment in South Africa* (2016) 437 439; Kelly-Louw and Marxen "General update on the law of demand guarantees and letters of credit" 2015 *Annual Banking Law Update* 276 300-301 par 4; and Graf von Westphalen and Zöchling-Jud (n 26) 632-633 par 112-114. Note, however, the critical remarks of Blesch, Meyer and Steinwachs *Rechtssicheres Avalgeschäft* (2014) 164 par 658; and again Graf von Westphalen and Zöchling-Jud (n 26) 633 par 115.

[43] On standard-form contracts in the construction industry in general, see par 2.6 *et seq* above.

[44] Kelly-Louw *Selective Legal Aspects of Bank Demand Guarantees* (2009) 479 (with reference to the URDG 458). Hugo (n 38) 160, writing on the URDG 758, agrees thus far and confirms that "it is not common in South Africa for guarantees to incorporate the URDG". See further Affaki and Goode (n 33) 438-439 par 599-602. FIDIC has also endorsed the URDG. See Baker, Mellors, Chalmers and Lavers *FIDIC Contracts: Law and Practice* (2009) 9 par 1.44; and Klee *International Construction Contract Law* (2015) 383 par 16.9.

[45] Malek and Quest (n 15) 349 par 12.32; Kelly-Louw (n 44) 153; and Horn *Bürgschaften und Garantien* (2001) 124 par 448.

international-style demand guarantees in the past.[46] To circumvent these restrictive regulations, US financial institutions simply employed regular letters of credit – which they were authorised to issue – and redressed them slightly to meet the business demand satisfied by abstract guarantees in other parts of the world.[47] By way of example, Hugo figuratively speaks of "instruments clothed as documentary credits, but serving the function of a guarantee or performance bond".[48] Scholars almost unanimously agree that in spite of the varying terminology, standby letters of credit can essentially be described as having the same characteristics or legal functions as "regular" demand guarantees.[49] Subsequently, it is not surprising to read that such standby letters of credit are "especially common in the construction industry".[50] For want of a specific uniform set of laws and guidelines, the parties in the US often made the standby letters of credit subject to the UCP.[51] The UCP, however, were said to be neither ideal nor entirely appropriate to govern a standby letter-of-credit transaction.[52] Against this background the ISP98 was developed as a tailored regulatory

[46] Davies and Snyder *International Transactions in Goods* (2014) 312; Nielsen and Nielsen "The German bank guarantee: lesson to be drawn for China" 2013 *George Mason Journal of International Commercial Law* 171 178; Bernhardt *Die Inanspruchnahme des Dokumentenakkreditivs* (2012) 21; Schütze and Edelmann *Bankgarantien* (2011) 28 par 3.2; Malek and Quest (n 15) 5 par 1.10; Haynes *The Law Relating to International Banking* (2010) 341-342 par 12.14; Coleman "Performance guarantees" 1990 *LMCLQ* 223 225-226; and Richter (n 1) 45-48. Interestingly, Japan is said to have a similar history and development due to legal obstructions towards demand guarantees. See Andrews and Millett *Law of Guarantees* (2011) 677 par 11-034; and Bishop *Finance of International Trade* (2004) 92. Further, see Kurkela *Letters of Credit and Bank Guarantees under International Trade Law* (2008) 17-18 for the general issue of restricting banks' ability to issue demand guarantees, especially n 29 at 18.

[47] Bernhardt (n 46) 21-22; Drobnig (n 12) 807 par 2 ("a substitute"); and Schütze *Das Dokumentenakkreditiv im Internationalen Handelsverkehr* (2008) 63 par 78.

[48] Hugo (n 1) 41 par 1 6 5.

[49] Carr *International Trade Law* (2014) 471; McKendrick (n 16) 1130 ("it is important to appreciate that the differences between a standby credit and a demand guarantee lie in business practice, not in law"); Kurkela (n 46) 17; Schütze (n 47) 62 par 74 ("Garantie und Standby Letter of Credit erfüllen gleiche wirtschaftliche Funktionen. Wegen des Ausschlusses von Einwendungen aus dem Grundgeschäft beim Standby Letter of Credit ist dieser der Garantie auf erstes Anfordern vergleichbar"); Barru (n 4) 61 ("These two instruments are functionally equivalent. Their primary difference pertains to nomenclature"); Andrews and Millett (n 46) 675 par 16-033 ("A standby letter of credit is a special form of letter of credit which essentially fulfils the same function as a performance guarantee"); Bishop (n 46) 93 ("The credit is therefore similar in many respects to an 'on demand' guarantee; it is different in form but produces the same result"); Dunn, Knoll and Dempsey "Letters of credit in construction projects" 2009 *The Construction Lawyer* 33 ("Standby letters of credit may be used in place of performance bonds"); Gao (n 27) 9 ("Because independent guarantees may properly be seen as legal synonyms of standby letters of credit"); and Horn (n 45) 39 par 136. Richter (n 1) 87-88 however, is somewhat unclear in this regard. In conclusion, the similarities between demand guarantees and standby letters of credit clearly merit their inclusion into this work, and reference to such standby letters and respective case law and commentary whenever appropriate.

[50] Hugo (n 1) 42.

[51] Bertrams (n 11) 30.

[52] Bertrams (n 11) 30; De Ly (n 10) 836; and Bishop (n 46) 92-93.

framework for standby letters of credit in the United States of America. Essentially therefore standby letters of credit serve the same purpose that demand guarantees do elsewhere.[53] The ISP98 enjoys considerable success in the USA,[54] and together with standby letters of credit themselves is spreading to other parts of the world.[55]

3.2.3 UNCITRAL Convention

The United Nations Convention on Independent Guarantees and Stand-by Letters of Credit (the UNCITRAL Convention), was finalised by the UNCITRAL Working Group on International Contract Practices in 1995 after almost seven years of negotiating and drafting.[56] The Convention was supplemented by an explanatory note compiled by the UNCITRAL secretariat.[57] Although the explanatory note itself contains a disclaimer that it may not be perceived as "an official commentary on the Convention", it can undoubtedly serve as an influential source of interpretational and comparative value.[58] The UNCITRAL Convention is primarily intended to govern "an international undertaking" (Art1 (1)), whereby the "international" component must be defined by taking into account Articles 1, 2 and 4.[59] Yet, most notably, this Convention not only makes direct and express reference to the

[53] Barru (n 4) 61 ("Standby letters of credit are instruments issued by banks in the United States, whereas bank guarantees are instruments issued by banks throughout the rest of the world"); and Graf von Westphalen and Zöchling-Jud (n 26) 635 par 127.

[54] Adodo *Letters of Credit the Law and Practice of Compliance* (2014) 11 par 1.16; Kelly-Louw (n 44) 153; and Horn (n 45) 124 par 448.

[55] Bishop (n 46) 92; Andrews and Millett (n 46) 621 par 16-003; Proctor *The Law and Practice of International Trade* (2015) 504 par 24.58; Graf von Bernstorff and Altmann *Zahlungssicherung im Außenhandel* (2007) 23 par 4.9 ("Nord- und Südamerika sowie Fernost"); Hugo (n 1) 43 par 1 6 5; Eschmann "Die Auslegungsfähigkeit eines Standby Letter of Credit" 1996 *RIW* 913 914; Coleman (n 46) 225-228; and Richter (n 1) 49-50 par C. Adodo (n 54) 25 par 1.62, however, holds a different view. The following cases from South Africa and England related to, *inter alia*, standby letters of credit: *Casey v Firstrand Bank Ltd* 2014 (2) SA 374 (SCA); *Union Carriage and Wagon Company Ltd v Nedcor Bank Ltd* 1996 CLR 724 (W); and *Mahonia Ltd v JP Morgan Chase Bank* [2003] 2 Lloyd's Rep 911.

[56] Bertrams (n 11) 28 par 2-12; and Lienesch (n 10) 1-2.

[57] Bertrams (n 11) 28 par 2-12.

[58] Hugo "Protecting the lifeblood of commerce: a critical assessment of recent judgments of the South African supreme court of appeal relating to demand guarantees" 2014 *TSAR* 661 664-665 n 27 regards the UNCITRAL Convention to be "the outcome of impressive comparative research".

[59] This necessitates, inter alia, that at least two parties to the transactions (the issuer, the beneficiary, or the applicant) have their places of business in different states. Incidentally, this poses the question whether parties by virtue of their party autonomy and contractual freedom may also voluntarily make the Convention applicable to their purely domestic transactions. The answer is probably in the affirmative, as long as the incorporation of the Convention does not bring about rules which are in conflict with mandatory domestic

independence principle, but also to possible exceptions to it.[60] For the UNCITRAL Convention to govern demand guarantees,[61] countries must first accede to it. Once this has happened, "the Convention has the force of law".[62] To date, only a few nations have actually ratified or acceded to the Convention,[63] a fact which has prompted commentators to be sceptical as to its success in attempting to harmonise the law of demand guarantees.[64] It has not been ratified or acceded to by the United Kingdom, South Africa or Germany.[65]

3.2.4 Concluding remarks

This short overview of the most important legal frameworks and rules available for demand guarantees should suffice at this point. Nevertheless, whenever necessary to illustrate and explain the principles and issues surrounding demand guarantees in specific contexts, the relevant provisions of the rules or Convention are referred to. Further, this introduction to the legal pluralism concerning demand guarantees serves to emphasise the complexities of this part of the law. It should be borne in mind, however, that even in the field of letters of credit (which are almost invariably issued subject to the UCP), diverging and inconsistent decisions

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laws prevalent in the country of business (for an opposing view see Heidbüchel (n 1) 88 par 4). However, while Art1(2) of the Convention allows for the application to international letter-of-credit transactions by way of contractual incorporation it seems still to necessitate the internationality of the undertaking. For the "internationality" of the UNCITRAL Convention as a stumbling block to further acceptance, see Graf von Westphalen and Zöchling-Jud (n 26) 634 par 119.

[60] Kelly-Louw (n 44) 474; Davidson (n 36) 26; Gao and Buckley "A comparative analysis of the standard of fraud required under the fraud rule in letter of credit law" 2003 *Duke Journal of Comparative and International Law* 293 333; and Gao (n 10) 50 ("In [sic] the international level, only the Convention has made an effort to deal with the issue" – insertion by me). Note that Gao regards cases of fraud to be "the issue" at hand.

[61] Regarding the parties' power to contract out of the UNCITRAL Convention, see Davidson (n 36) 29-30; Dunn, Knoll and Dempsey (n 49) 34; and De Ly (n 10) 839.

[62] Quote from Enonchong (n 20) 41 par 3.40. Similar also Davidson (n 36) 26. Enonchong added that parties are free to contract out of the Convention if they prefer to do so (42 par 3.40); likewise Dunn, Knoll and Dempsey (n 49) 34.

[63] Belarus, Ecuador, El Salvador, Gabon, Kuwait, Liberia, Panama, and Tunisia have acceded to or ratified the Convention; the United States is a signatory to the Convention since 1997 but has not acceded to or ratified it yet.

[64] Kelly-Louw and Marxen (n 42) 300-301 par 4. However, see also the remarks of De Ly (n 10) 837 who also puts emphasis on the "particular countries which ratify" the Convention as a yardstick to measure success. Admittedly, this criterion will probably not change the view that the UNCITRAL Convention is unsuccessful, given the absence of most industrialised countries. Furthermore, take note of his list of "drawbacks" of the Convention (at 845-846).

[65] Regarding South Africa and the UNCITRAL Convention, see the recommendations by Kelly-Louw (n 44) 485-486; for the lack of acceptance in the United Kingdom, Graf von Westphalen and Zöchling-Jud (n 26) 634 par 118.

arise from different jurisdictions. This emanates from the independent, distinct way of interpretation and application of the UCP by domestic courts or arbitral tribunals. Judges are likely to follow their own familiar ways of approaching certain legal issues like statutory ambiguity, interpretation and construction of contracts, evaluation of parties' intentions or similar matters. It stands to reason that due to the coexistence of different frameworks (none of which are uniformly applied) governing demand guarantees, this part of the law is more diverse than that of letters of credit.[66]

3.3 Definition, terminology, parties, establishment and discharge of demand guarantees in their most simple form

A demand guarantee is essentially a contract in which the guarantor, usually a bank, promises to pay a certain sum of money to the beneficiary upon a first demand alleging a certain event.[67] Such an event, for instance insolvency or breach of an underlying contract by the applicant, does not need to be proven but merely stated and often supported (prima facie) by documents pointing to such facts (such as a written statement by the beneficiary alleging breach of contract, a cancellation notice, a certificate by an expert and a court order).[68] Upon receipt of a conforming demand, the guarantor must honour the guarantee, irrespective of any disputes relating to the performance of the parties' obligations arising from the underlying contract (for example the building or service contract).[69] Save for exceptional circumstances,[70] the beneficiary can thus be certain that it will receive the money promised under the guarantee, and any objections by the applicant as to the actual entitlement of the

[66] However, note also the comment to the contrary in Bertrams "The new forms of security in FIDIC's 1999 conditions of contract" 2000 *The International Construction Law Review* 369 372.

[67] Bertrams (n 11) 8 par 1-5 and 46 par 4-2 *et seq*; Enonchong (n 20) 29-30 par 3.01; Wood *International Loans, Bonds, Guarantees, Legal Opinions* (2007) 370 par 20-015; and Pierce (n 10) 14 ("main source of demand guarantees is banks").

[68] *State Bank of India v Denel SOC Limited* [2015] 2 All SA 152 (SCA) par 9 (per Fourie AJA); Bertrams (n 11) 47 par 4-3 *et seq*; Giesinger "Sicherung von Forderungen nach österreichischem Recht" in DACH Europäische Anwaltsvereinigung *Sicherung von Forderungen unter Berücksichtigung der Rechtsinstitute: Garantie, Eigentumsvorbehalt, Bauhandwerkerpfandrecht etc.* (2005) 73 75; Gao (n 27) 8-9; Lienesch (n 10) 14 par 1; and Pierce (n 10) 20-21.

[69] *First Rand Bank v Brera* 2013 (5) SA 556 (SCA) par 2 (per Malan JA); *State Bank of India v Denel SOC Limited* (n 68) par 8 (per Fourie AJA); Wood (n 67) 370-371 par 20-015; and Pierce (n 10) 21.

[70] This thesis discusses these "exceptional circumstances" in greater detail below (chapter 5-7).

beneficiary to the proceeds must be dealt with separately between applicant and beneficiary in accordance with the underlying contract.[71]

In regard to documentary letters of credit, the terminology employed by scholars and practitioners is generally clear and precise, as only a limited number of terms are commonly used (documentary credits, letters of credit, commercial letters of credit and bankers' documentary credit in English; and "Dokumentenakkreditiv" or "Akkreditiv" in German). This stands in stark contrast to the wide and potentially misleading variety of terms and expressions used in relation to demand guarantees, which, according to Bertrams, leads to "confusion, uncertainty and inconsistency".[72] In the same vein Bailey states: "The terminology used to describe individual instruments varies, which can often lead to confusion as to the nature of the instrument."[73] He continues to identify eleven terms, which essentially describe the same kind of legal undertaking, namely:

> "performance bond", "performance guarantee", "bank guarantee", "banker's guarantee", "banker's undertaking", "on-demand bond", "first demand bond", "form of performance security", "single bond", "simple demand bond" and "standby letter of credit".[74]

This, however, is not a complete list. Further terms that regularly appear in scholarly articles, judgments and textbooks include "unconditional guarantee", "abstract guarantee" and "demand guarantee".[75]

Therefore, it is of utmost importance for parties to a demand-guarantee transaction to make use of clear, precise and appropriate language when finalising such a contract.[76]

[71] Wood (n 67) 371 par 20-017; Blesch, Meyer and Steinwachs (n 42) 162-163 par 654; and Coleman (n 46) 224-225 and 230 ("the beneficiary knows he will obtain immediate compensation without the need to resort to the courts or extensive negotiations").

[72] Bertrams (n 11) 4 par 1-2. Further, see Hellner and Steuer *Bankrecht und Bankpraxis* (2006) par 5/251; Drobnig (n 12) 806 par 1; Haynes (n 46) 276 par 10.2; Lurie "On-demand performance bonds: is fraud the only ground for restraining unfair calls?" 2008 *The International Construction Lawyer* 443 444; Dixon "As good as cash? The diminution of the autonomy principle" 2004 *Australian Business Law Review* 391 393-394; *Kelly-Louw* "General update on the law of demand guarantees and letters of credit" 2016 *Annual Banking Law Update* 43 44; and Coleman (n 46) 223 ("Terminological confusion flourishes in this field") and 228 ("absence of a common terminology").

[73] Bailey *Construction Law Volume II* (2011) 915.

[74] Bailey (n 73) 915.

[75] See for example Wong (n 7) 52 par 2.1; Dalby "A performance bond, deconstructed" 2010 *Business Law International* 105; and Kelly-Louw (n 44) 1-2 and 7-9. Incidentally, she opted for the term "demand guarantee" (see her n 3) in her doctoral thesis. Wong, on the other hand, seems to support the use of "demand bonds" so as to avoid any confusion with traditional secondary "guarantees" (in his article most distinct at 53-54).

Otherwise, there is the ever-present danger that it could be misunderstood and dealt with as an accessory guarantee.[77] This, obviously, can defeat the very purpose of the guarantee and leave the beneficiary with insufficient security. Throughout this thesis, the term "demand guarantee" is favoured.[78] The avoidance, as much as reasonably possible, of the word "bank" in the name recognises the fact that today such guarantees are also issued by insurance companies and other financial institutions.[79]

The main, indispensable parties to a demand guarantee are the applicant, the guarantor and the beneficiary.[80] To illustrate their respective roles, it is convenient to examine the basic process leading to the issuance of a demand guarantee and its subsequent calling up.[81]

First of all, the creditor in the underlying contract sets out its expectations relating to the guarantee to the debtor in the underlying contract (for instance a building contract).[82]

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[76] Wilmot-Smith *Construction Contracts Law and Practice* (2010) 14-195 par 9.23-9.26; Apathy, Iro and Koziol (n 9) 239-250; Broekhuizen (n 10) 100; and Affaki *ICC Uniform Rules on Demand Guarantees a User's Handbook to the URDG* (2001) 125 par 177. See also the remarks of Graf von Westphalen and Zöchling-Jud (n 26) 617-621 par 55-59. The many available standard-form demand guarantees are, when sufficiently tested in courts and arbitral proceedings, of great help in this regard.

[77] Wilmot-Smith (n 76) 195 par 9.26; and Broekhuizen (n 10) 97-100. Further, note the instructive table presented by Wong (n 7) 68-71 for recent case law dealing with the particular wording of (demand) guarantees. For the fundamental differences between primary and independent instruments (letters of credit, demand guarantees), as opposed to mere secondary, accessory security (traditional contract of guarantee, suretyship, "Bürgschaft") see par 3.4 *et seq* and par 4.5.2 below.

[78] McKendrick (n 16) 1129 traced the "coming into use" of the term "demand guarantee" to the advent of the URDG (note, however, that he referred to the URDG 458.

[79] Kelly-Louw and Marxen (n 42) 229-300. See also Panagiotopoulos *Die Rückforderung unbegründeter Zahlungen bei einer Bankgarantie 'auf erstes Anfordern'* (2007) 15 (especially his n 58); Nielsen and Nielsen (n 46) 174-175 as well as 180-181; Broccoli and Adams "On –demand bonds: a review of Italian and English decisions on fraudulent or abusive calling" 2015 *International Construction Law Review* 103 104 (banks and "other commercial finance provider"); Hugo (n 15) 17 par 6 (i); and Edwards, Lord and Madge *Civil Engineering Insurance and Bonding* (1996) 101 ("banks or insurance companies").

[80] Although commentators constantly reiterate this triangular-relationship model (see for instance Schütze (n 47) 46 par 38), one could argue that two parties suffice for a demand guarantee. See, for instance, Gao (n 10) 51 and his n 11; and Affaki and Goode (n 33) 12 par 27. Focusing closely on the actual, immediate parties to the guarantee, Bertrams observes correctly that "[a] guarantee is a contract between two parties, namely the guarantor [...] and the beneficiary [...]" (Bertrams (n 11) 15 par 2-3, alterations and omissions by me). This, permissibly, puts a narrow focus on the parties directly involved, while ignoring the broader relationship which would include the applicant as a third party. Furthermore, consider the case where a bank secures its own obligation (arising under a contract of sale, lease or credit agreement for example) by issuing a demand guarantee or letter of credit as additional security. Affaki and Goode (n 33) 12 par 27, provide examples. See also Langenbucher, Bliesener and Spindler (n 10) 1818-1819 par 2. In such a scenario, the bank would assume the role of both applicant/original debtor and also guarantor, which again supports the notion that indeed only two parties are truly essential.

[81] For purposes of this thesis the focus is (mainly) on rather simple, three-party-guarantees (applicant, guarantor, beneficiary), as opposed to relationships in which four or even more parties are involved (counter-guarantor, confirming and advising banks and so forth). See Kelly-Louw (n 44) 30-33 for instructive reading in this regard.

Once they have reached agreement, the debtor applies to the guarantor for the issuance of a guarantee in accordance with the agreement between the debtor and the creditor.[83] The debtor accordingly becomes the applicant for, and the creditor the beneficiary of, the guarantee. The applicant and the guarantor enter into a contract of mandate,[84] which determines the relationship between these two parties.[85] If the guarantor, usually a bank, insurance company or another institution of similar financial strength and standing,[86] (i) deems the applicant to have sufficient solvency and creditworthiness,[87] and (ii) regards the particular modalities and conditions of the guarantee acceptable,[88] it will issue the guarantee. From this moment on the beneficiary can demand payment from the guarantor in accordance with the (documentary) conditions stated in the guarantee. The guarantor's obligations as against the beneficiary are

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[82] See Drobnig (n 12) 807 par 3; Furst and Ramsey *Keating on Construction Contracts* (2012) 397 par 11-034; Malek and Quest (n 15) 5 par 1.10; Graf von Westphalen *Rechtsprobleme der Exportfinanzierung* (1987) 367 par 9 a; Haynes (n 46) 291; Ellinger and Neo *The Law and Practice of Documentary Letters of Credit* (2010) 60; and Cranston *Principles of Banking Law* (2002) 385 (even though some of the mentioned authors refer to the inception of a letter of credit, their remarks are equally valid in respect of a discussion of demand guarantees). Again, this is subject to the individual agreement and the bargaining power of the parties to the underlying contract (that is the applicant/debtor and the beneficiary/creditor).

[83] Enonchong (n 20) 43 par 3.47 ("The instructions given by the account party to his bank should be in accordance with the terms agreed in the underlying contract otherwise the beneficiary may refuse to accept the guarantee").

[84] Kurkela (n 46) 81. In German law, this contract of mandate between the bank and the applicant would most likely be classified as a so-called "Geschäftsbesorgungsvertrag". See Einsele *Bank- und Kapitalmarktrecht* (2014) 153-154 par 54; Ehrlich and Haas *Zahlung und Zahlungssicherung im Außenhandel* (2010) 436 par 9/73; Panagiotopoulos (n 79) 20; and Wassermann *Die Verwendung von Ansprüchen aus Dokumentenakkreditiven* (1981) 29 par B.

[85] It is important to note that restrictions or agreements captured in this contract of mandate only operate between the parties to the contract of mandate, that is the applicant and the guarantor. As a result of the principle of independence, the doctrine of privity of contract, *Relativität der Schuldverhältnisse* and similar notions, the guarantor generally may not utilise any particulars of the contract of mandate to obtain a defence against the beneficiary. See, for example, Bertrams (n 11) 114 par 9-5 and 203-204 par 12-2; as well as Kelly-Louw (n 44) 63 par 2.5.2.3.

[86] Drobnig (n 12) 807 par 3; Loh and Wu "Injunctions restraining calls on performance bonds – is fraud the only ground in Singapore?" 2000 *LMCLQ* 348 349; Furst and Ramsey (n 82) 397 par 11-034; Bailey (n 73) 914 par 12.48; Wilmot-Smith (n 76) 194 par 9.22; Graf von Westphalen and Zöchling-Jud (n 26) 609 par 34; Häberle (n 1) 838; and Edwards, Lord and Madge (n 79) 101.

[87] This stems from the process of reimbursement, in which the guarantor is entitled to recoup from the applicant the monies that he has paid out to the beneficiary under the instrument. This claim for reimbursement originates from the contract of mandate (see above) between the applicant and the guarantor (Kurkela (n 46) 81-82). However, often the guarantor will require the applicant to have made available a cash deposit or other forms of security prior to the guarantee being issued. See Bertrams (n 11) 22-25; Drobnig (n 12) 807 par 3; Brindle and Cox *Law of Bank Payments* (2010) 851 par 8-114 *et seq*; Kurkela (n 46) 82-83; and Coleman (n 46) 223-224.

[88] See, for example, Graf von Westphalen (n 82) 367-368 par 9a. As the terms of the instrument itself almost exclusively determine the obligations of the guarantor – including possible defences or the lack thereof – it has to make sure that such a guarantee is appropriately formulated and drafted. Main points of interest are – *inter alia* – the stipulated amount of money, identities of the parties, expiry date and the precise (documentary) conditions upon which payment is due to the beneficiary. See also par 8.3 below.

thus determined in the instrument itself,[89] and are independent[90] of the underlying contract between the applicant and the beneficiary, as well as the contract of mandate between the applicant and the guarantor.

To demand payment under the instrument, the beneficiary[91] must comply with the conditions of the guarantee. This entails the submission of documents, exactly as stipulated in the guarantee (as in the case of a letter of credit).[92] The conditions of the guarantee are accordingly documentary in nature. The guarantor will examine the presented documents, and if satisfied that they are in conformity with the guarantee, honour the obligation, that is pay out the amount claimed in accordance with the terms of the guarantee.

To recoup the monies paid to the beneficiary under the instrument, the guarantor is entitled under the contract of mandate to reimbursement from the applicant.[93] Once this has occurred, the process of a demand-guarantee transaction – in its simplest form – is concluded. This very basic introduction to the mechanics of a demand-guarantee transaction should suffice at this stage.

The preferred terms in this thesis for the key parties involved in the demand guarantee are applicant, guarantor and beneficiary. Their interaction and distinct relationships are examined and evaluated further in various contexts below.

[89] That is the demand guarantee or the letter of credit.

[90] The independence of the guarantor's obligation from the original underlying contract is the fundamental difference in comparison to secondary, accessory payment undertakings like suretyship, the traditional contract of guarantee and the German "Bürgschaft". See par 4.5.2 below.

[91] For the interesting question whether the demand may be made by a duly authorised agent of the beneficiary, see *University of the Western Cape v ABSA Insurance Company Ltd* [2015] ZAGPJHC 303 (28 October 2015), especially par 3-12 (per Fourie J). See further par 6.3.2 below.

[92] This refers to the doctrine of documentary compliance, according to which the claim on the demand guarantee or letter of credit is triggered by the presentation of documents which are prescribed in detail in the instrument itself. See par 3.4.3, and par 6.2 *et seq* below.

[93] See Bertrams (n 11) 116-117 par 10.2.1-10.2.3; Enonchong (n 20) 294 par 12.70 (who states that a claim for reimbursement will be based on an implied indemnification agreement should the contract of mandate fail to contain an express agreement); and Mader "Zur Rückabwicklung bei der Bankgarantie" in Apathy, Bollenberger, Bydlinski, Iro, Karner and Karollus *Festschrift für Helmut Koziol zum 70. Geburtstag* (2010) 1041. In practice, first of all the guarantor will usually assess the financial strength and reputation of the applicant. According to the outcome of such an evaluation, the guarantor can either rely solely on the goodwill and financial reputation of the applicant, or demand a cash advance or another form of security to secure its reimbursement in case of a call on the instrument, Bertrams (n 11) 122 par 10-7; and Andrews and Millett (n 46) 629 par 16-007 as well as 632. Note the critical remarks in this regard of Canaris *Bankvertragsrecht Erster Teil* (1988/2005) 754 par 1113; and Garner *JBCC 2014 and all that* (2014) 30.

3.4 Demand guarantees: major doctrines (independence and documentary compliance)

3.4.1 Introduction

Demand guarantees, similar to letters of credit, are generally built upon two important foundations namely, in the first place, the *principle of independence*, and secondly the *principle of documentary compliance*. These two principles are indispensable to payment and security instruments such as these, and crucial factors for their success in international commerce. The two principles are dealt with briefly immediately below and are revisited in more detail later.

3.4.2 Principle of independence

3.4.2.1 Introduction

The principle of independence, also referred to as the principle of autonomy, the principle of abstraction or the doctrine of separation,[94] is fundamental in demand guarantees and letters of credit.[95] For purposes of this study, it is important to lay out this principle of independence in more detail, as it sets the background against which the broader question of abusive calls on demand guarantees – and potential defences – can be evaluated. The independence principle is best understood when initially approached from the position of the beneficiary, and its expectations. Wood noted concisely that "[t]he objective of the beneficiary of the guarantee is to be absolutely certain that it will be paid regardless of objections by the [applicant]".[96] Using Wood's words as a point of departure, the principle of independence must therefore detach the payment obligation under the instrument (the demand guarantee or letter of credit)

[94] Enonchong "The autonomy principle of letters of credit: an illegality exception?" 2006 *LMCLQ* 404 ("principle of autonomy"; "independence principle"); Mugasha *The Law of Letters of Credit and Bank Guarantees* (2003) 24; Broekhuizen (n 10) 95 ("abstracted"); and Coleman (n 46) 223 ("separation").

[95] Antoniou "Nullities in letters of credit: extending the fraud exception" 2014 *Journal of International Banking Law and Regulation* 229 230; McKendrick (n 16) 1079-1082 and 1138-1140; Kelly-Louw (n 44) 56 par 2.5.2.2 (for letters of credit) and 58 (for demand guarantees); Enonchong "The problem of abusive calls on demand guarantees" 2007 *LMCLQ* 83 84; Enonchong (n 94) 404 ("Among the principles that are fundamental in the law of letters of credit is the principle of autonomy (also known as the independence principle)"); Hugo "Discounting practices and documentary credits" 2002 *SALJ* 101 105; and Kaya (n 1) 19 ("Die Abstraktheit des Zahlungsversprechens ist für das Akkreditiv kennzeichnend"). But see also the criticism in Debattista (n 28), especially 302 *et seq* who argues strongly against the independence principle in demand guarantees.

[96] Wood (n 67) 371 par 20-016 (alteration and insertion by me).

from the performance of the underlying contract (for example the construction contract, service contract or contract of sale).

Hence, it is universally accepted that the beneficiary's claim in terms of a demand guarantee is independent of any entitlement and possible defences arising in connection with the contract between applicant and beneficiary.[97] The guarantor's obligation under a demand guarantee arises solely from the instrument itself, and strictly in line with the terms and conditions set out in this instrument.[98] This principle has received much attention in case law.

3.4.2.2 Case law and commentary

In a much cited English judgment, Lord Denning held:

> "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 the 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."[99]

Therefore, the bank as a guarantor must generally disregard any objections by the applicant as to the performance (or lack thereof) regarding the underlying contract, and may not use such allegations as a defence against the call on the guarantee.[100] The bank's own payment obligation is therefore independent, abstract and autonomous. There is only a very tenuous link with the underlying contractual relation between the applicant and the beneficiary. It is often reiterated, quite vividly, that any demand guarantee or letter of credit must be and in fact almost is "the equivalent of cash in hand".[101] The situation of a party in whose favour a

[97] Note also that the secured transaction does not necessarily have to be one between the applicant and the beneficiary, for instance in more complex situations with more than three parties involved in the broader transaction.

[98] Bailey (n 73) 915 (omission and insertion by me); McKendrick (n 16) 1079; Drobnig (n 12) 807 par 3; and the judgment *First Rand Bank v Brera* (n 69) par 2 (per Malan JA).

[99] *Edward Owen Engineering Ltd v Barclays Bank International Ltd* [1978] QB 159 171 par A-B.

[100] See *State Bank of India v Denel SOC Limited* (n 68) par 8 (per Fourie AJA); *Coface South Africa Insurance Co Ltd v East London Own Haven t/a Own Haven Housing Association* 2014 (2) SA 382 (SCA) par 10-13 (per Navsa ADP and Pillay JA); *Lombard Insurance Company Ltd v Landmark Holding (Pty) Ltd* 2010 (2) SA 86 (SCA) par 20 (per Navsa JA); and *Loomcraft Fabrics CC v Nedbank Ltd* 1996 (1) SA 812 (A) 816 (per Scott AJA).

[101] *Intraco Ltd v Notis Shipping Corp (The "Bhoja Trader")* [1981] 2 Lloyd's Rep 256 258 ("the equivalent of cash in hand", per Donaldson LJ); Enonchong (n 20) 68 par 4.04 ("equivalent to cash in hand") and 81 par 4.37 ("cash equivalence"); O'Donovan and Phillips *The Modern Contract of Guarantee* (2010) 881 par 13-

demand guarantee has been issued is, therefore, very comfortable and secure. Apart from the possibility of proceeding against the applicant in terms of the underlying contract, the demand guarantee offers the beneficiary an additional, legally separate and very firm basis upon which to claim. The term "second pocket" is often used in regard to having an additional debtor, for instance in cases relating to traditional suretyship or accessory guarantees.[102] The term may be also used in the context of demand guarantees, provided one draws attention to the fact that the beneficiary now holds two legally distinct claims against different parties, based on different rights and relationships.[103] First, there is the original claim based on the underlying contract, for example a claim for damages for breach of contract. This claim is not affected or barred by the existence of the demand guarantee.[104] However, it is subject to legal defences, possible delaying tactics, and problems relating to burden of proof, admissibility of evidence and so forth. The right under the guarantee however, the "second pocket", entitles the beneficiary to claim against the guarantor without reference to the underlying contract.[105] Potential defences and objections originating from the underlying contract (such as malperformance) between applicant and beneficiary are in principle irrelevant.[106] So, despite the fact that the demand guarantee is "a product of the underlying relationship",[107] the obligation of the guarantor is independent of it. In *Lombard Insurance Co Ltd v Landmark Holdings (Pty)*, the South African Supreme Court of Appeal put it thus (per Navsa JA):

> "The guarantee by [the guarantor] is 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 […]. This obligation is wholly independent of the underlying

13 ("the equivalent of cash"); and Todd *Bills of Lading and Bankers' Documentary Credits* (2007) 255 par 9.82 ("Performance bonds, like documentary credits, are treated as the equivalent of cash").

[102] Wood (n 67) 337 par 18-002 (with regard to traditional, secondary guarantees).

[103] See, for example, Panagiotopoulos (n 79) 14-15; and Ellinger and Neo (n 82) 330 par IV.

[104] See Enonchong (n 20) 11-12 par 2.12-2.15; and Canaris (n 93) 787 par 1151.

[105] Bülow *Recht der Kreditsicherheiten* (2012) 568 par 1543.

[106] As was emphasised in *Coface South Africa Insurance Co Ltd v East London Own Haven t/a Own Haven Housing Association* (n 100) par 10-13 (per Navsa ADP and Pillay JA); *Lombard Insurance Company Ltd v Landmark Holding (Pty) Ltd* (n 100) par 20 (per Navsa JA); and *Loomcraft Fabrics CC v Nedbank Ltd* (n 100) 816 (per Scott AJA).

[107] Bertrams (n 11) 71. See further Kurkela (n 46) 105 who argues that "[a] letter of credit or guarantee remains always formally accessory to the underlying transaction and its right of existence is based on serving the purpose of the 'main' transaction: forming a facility or 'function'".

> contract […]. Whatever dispute may subsequently arise between [applicant] and [beneficiary] is of no moment insofar as the bank's obligation is concerned."[108]

Hence the structural similarities between demand guarantees and letters of credit and the concomitant principle of independence have been clearly recognised by the South African courts.[109] In the words of Mthiyane AP, the "bank is in the business of handling money, not assessing and evaluating the merits or demerits of contracts",[110] and "[h]ence the obligation to pay arises from the terms of the guarantee and not from the conditions of the construction contract to which the Bank is not a party".[111]

Historically, the general notion of abstract payment and security devices was created and derived from the actual needs and requirements in industry and (international) commerce, which required effective and secure instruments to guard their transactions.[112] Thus, in the context of letters of credit, Hugo argued: "[I]t is important to bear in mind that the documentary credit is essentially a *mercantile*, rather than a legal device. It was created by merchants and bankers to fulfil a specific mercantile need."[113] Even though he referred to letters of credit, his argument can be accepted as equally valid in the realm of demand guarantees. Drobnig[114] remarks that "[e]arlier than in the field of contract law, the [independent] guarantee was implemented in commerce, in particular in international trade". So with the requests by the merchant community for (international) abstract payment and security instruments, the independence principle was eventually recognised and accepted by

[108] *Lombard Insurance Company Ltd v Landmark Holding (Pty) Ltd* (n 100) par 20 (alteration, insertion and omission by me).

[109] For a further recent South African affirmation, see *First Rand Bank v Brera* (n 69).

[110] *Eskom Holdings v Hitachi Power Africa* [2013] ZASCA 101 (12 September 2013) par 9 (per Mthiyane AP).

[111] *Eskom Holdings v Hitachi Power Africa* (n 110) par 18 (per Mthiyane AP, alteration by me).

[112] Hugo (n 15) 6 *et seq*; Hök (n 12) 557 par 7; Schütze (n 47) 44 par 32; Gao (n 27) 11-12; and Bertrams (n 66) 372.

[113] Hugo (n 1) 1 (insertion and alteration by me). See also Graf von Westphalen "Neue Tendenzen bei Bankgarantien im Außenhandel?" 1981 *WM* 294 par I ("Es bedarf kaum der Hervorhebung: Die Bankgarantie ist eine Schöpfung des internationalen Handels- und Wirtschaftsverkehrs").

[114] Drobnig (n 12) 806-807 par 2 (alteration and insertion by me).

the law.[115] This legal development is entirely in line with the general observation that "[c]ommercial law has arisen to a considerable degree out of commercial practice".[116]

3.4.2.3 Legal frameworks

The principle of independence is recognised in all the frameworks introduced above.[117] The relevant section of the URDG 758 reads:

> "A guarantee is by its nature independent of the underlying relationship and the application, and the guarantor is in no way concerned with or bound by such relationship. A reference in the guarantee to the underlying relationship for the purpose of identifying it does not change the independent nature of the guarantee. The undertaking of a guarantor to pay under the guarantee is not subject to claims or defences arising from any relationship other than a relationship between the guarantor and the beneficiary."[118]

The ISP98 states the principle in the following terms:

> "A standby is an irrevocable, independent, documentary, and binding undertaking when issued and need not so state. […] Because a standby is independent, the enforceability of an issuer's obligation under a standby does not depend on: (i) the issuer's right or ability to obtain reimbursement from the applicant; (ii) the beneficiary's right to obtain payment from the applicant; (iii) a reference in the standby to any reimbursement agreement or underlying transaction; or (iv) the issuer's knowledge of performance or breach of any reimbursement agreement or underlying transaction."[119]

Finally, the UNCITRAL Convention provides:

> "For the purposes of this Convention, an undertaking is independent where the guarantor/issuer's obligation to the beneficiary is not: (a) Dependent upon existence or validity of any underlying transaction, or upon any other undertaking (including stand-by letters of credit or independent guarantees to which confirmation or counter-guarantees relate); or (b) Subject to any term or condition not appearing in the undertaking, or to any future, uncertain act or event except presentation of documents or another such act or event within the guarantor/issuer's sphere of operations."[120]

The URDG makes use of a very clear and unambiguous provision in an almost "imperative" manner. It declares that "[a] guarantee is by its nature independent […]", without adding any

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[115] For instance, see De Eizaguirre "Die Garantie auf erstes Anfordern – Neueste Entwicklung in der spanischen Rechtsprechung" in Heldrich, Prölls and Koller *Festschrift für Claus-Wilhelm Canaris zum 70. Geburtstag Band II* (2007) 521 ("Der moderne Rechtsverkehr hat mit der Garantie auf erstes Anfordern […] eine besondere Art von Personalsicherheit entwickelt" – insertion and omission by me).

[116] Hopt "Commercial law" in Basedow, Hopt, Zimmermann and Stier *The Max Planck Encyclopedia of European Private Law Volume I* (2012) 252 253 (insertion and alteration by me).

[117] See par 3.2.1-3.2.3 above.

[118] URDG Art5(a) (Independence of guarantee and counter-guarantee).

[119] ISP98 rule 1.06 (omission by me). Throughout the ISP98 the principle of independence is underscored in several rules.

[120] UNCITRAL Convention Art3 (Independence of undertaking).

further preconditions. The ISP98 contains a similar rule. The UNCITRAL Convention, on the other hand, seems to impose certain preconditions for a guarantee to be regarded as truly independent. It accepts a guarantee to be independent only if it is not "[d]ependent upon the existence or validity of any underlying transaction".[121] In order to appreciate this approach, one must take into account the different legal nature of the frameworks. The URDG and the ISP98 are elective sets of rules, which may be chosen by the parties and incorporated to govern a demand-guarantee transaction.[122] The UNCITRAL Convention, however, would apply by default to demand-guarantee transactions in signatory states.[123]

While the individual provisions in the regulatory frameworks differ in their particular wording and elaborateness, it is easy to appreciate their common denominator – the acknowledgement of the independence principle. Given the conceptual difference in the legal nature of the URDG and the ISP98, as opposed to the UNCITRAL Convention, the diverging provisions in these sets of rules dealing with the independence principle are understandable.

3.4.2.4 Pay first, argue later

The implications brought about by the principle of independence in demand guarantees and letters of credit are often summarised in the phrase "pay first, argue later".[124] In essence, it means that the beneficiary of a demand guarantee can expect payment under the guarantee as soon as it is able to tender the documents stipulated in the demand guarantee,[125] irrespective of the underlying contract between it and the applicant and without regards to any disputes

[121] UNCITRAL Convention Art3(a) (insertion and alteration by me).

[122] See the earlier discussion, par 3.2.1 above.

[123] This, obviously, is a convenient simplification of the issues concerning the applicability of the UNCITRAL Convention, as more factors may be relevant (scope of the Convention, internationality of the undertaking and so forth). Therefore, see the earlier discussion above (par 3.2.3).

[124] Bertrams (n 11) 73-74; Bernhardt (n 46) 69 ("Zuerst bezahlen, dann prozessieren"); Apathy, Iro and Koziol (n 9) 230 par 3/8 ("Zuerst zahlen, dann streiten" – emphasis omitted by me); Dunham "The use and abuse of first demand guarantees in international construction projects" 2008 *The International Construction Law Review* 273 290 ("pay first argue later"); Wood (n 67) 371 par 20-017 ("pay first, litigate later"); Dixon, Gösswein and Button "On-demand performance bonds in the international market and adjudication as a means of reducing the risks" 2005 *The International Construction Law Review* 284 286 ("pay first, sue later"); and Broekhuizen (n 10) 97.

[125] For a discussion of the principle of strict compliance/documentary compliance and stipulated documents, see par 3.4.3 and par 6.2 *et seq* below. Note, also, that the demand guarantee may well be drafted so as to have a simple written demand suffice – without any further documents at all.

arising from this underlying relationship.[126] Allegations of breach of contract, failure to fulfil contractual duties arising from the underlying contract are, at this stage, immaterial. They are put on hold and can be dealt with later in proceedings between the applicant and the beneficiary arising from the underlying contract (as opposed to the guarantee).[127] This is essentially the heart of independence – which distinguishes this type of guarantee from an accessory guarantee or suretyship (or, in German law, "Bürgschaft"). Therefore, it is of great importance, in drafting demand guarantees, that their independent nature emerges clearly from the instrument. Applicants, otherwise, are likely to argue that the guarantee is accessory and that the entitlement of the beneficiary must be established in terms of the underlying contract for it to be able to enforce payment of the guarantee. Factors such as the proper construction of the contract, the true interpretation of the terms and intentions of the parties, the reasonable expectations of the parties, the surrounding circumstances and the clarity of the language will have to be taken into account when determining such disputes.[128]

3.4.2.5 Exceptions to the independence principle

The independence principle, however, is not absolute. Exceptions to it have emerged in many jurisdictions. The independence principle can probably be said to serve the interests of the beneficiary – its right to payment irrespective of underlying disputes originating from the underlying contract.

[126] The reluctance to intervene in the payment of demand guarantees is evident, for example, in *National Infrastructure Development Co Ltd v Banco Santander SA* [2016] EWHC 2990 (Comm) (par 24 "save perhaps in the plainest case"; par 25 "authority shows the importance of rigour"; par 29 "straightforwardness for which the parties […] bargained"; par 31 "standby letters of credit must work in accordance with their terms"). See also Bertrams (n 11) 11; Enonchong (n 20) 93 par 4.61; Ellinger and Neo (n 82) 116; and Bülow (n 105) 574-575 par 1561 and 1563.

[127] Wood (n 67) 371 par 20-017; Giesinger (n 68) 78; and Coleman (n 46) 224-225. For the contentious issue whether the guarantor itself may reclaim payment from the beneficiary in certain instances, see Mader (n 93) 1042 *et seq*.

[128] *Marubeni Hong Kong and South China Ltd v Government of Mongolia* [2005] All ER (D) 117 (Apr); *Minister of Transport and Public Works, Western Cape v Zanbuild Construction (Pty) Ltd* 2001 (5) SA 528 (SCA); *Lombard Insurance Company Ltd v Stewart* [2016] ZAKZPHC 91 (11 October 2016) par 8 *et seq*; *Mutual and Federal v KNS Construction* [2016] ZASCA 87 (31 May 2016); *Kuehne and Nagel Ltd v Moncada Energy Group SRL* [2016] ZAGPJHC 26 (19 February 2016) par 19 *et seq*; *Desertmoon Trading 355 CC v Clyde Bergeman Africa (Pty) Ltd* [2015] ZAGPPHC 914 (4 September 2015); Chambers *Hudson's Building and Engineering Contracts* (2010) 1332-1337 par 10-056-10-058; Kelly-Louw (n 72) 50 *et seq*; and Ndekugri "Performance bonds and guarantees: construction owners and professionals beware" 1999 *Journal of Construction Engineering and Management* 428 430-431.

Hence, Enonchong notes "a position of power in relation to the bank and the [applicant]"[129] and, similarly, Ellinger and Neo refer to "enormous power [in] the hands of the beneficiary".[130] This is a manifestation of the important concept of legal certainty[131] which, in the case of demand guarantees and letters of credit, translates into the beneficiary's ability to realise the independent payment and security instrument as soon as it obtains the required documents, if any,[132] and makes a complying demand. The comparison of a demand guarantee with "cash in hand" above[133] is therefore fitting. Such power in the hands of the beneficiary, if unchecked, however, can lead to major injustice in certain circumstances. It is for this reason that the law has recognised exceptions to the independence principle.

Fraud

The so-called "fraud exception" was first developed in regard to letters of credit, but also plays an important part in the prevention of abusive calls on demand guarantees.[134] This exception can perhaps[135] be regarded as the only true exception to the independence principle relating to both letters of credit and demand guarantees.[136] Many authors[137] trace the fraud

[129] Enonchong (n 20) 93 par 4.61 (alteration by me).

[130] Ellinger and Neo (n 82) 309 (alteration by me). See also Horn "Bürgschaften und Garantien zur Zahlung auf erstes Anfordern" 1980 *NJW* 2153 ("Sie verschaffen dem Berechtigten die denkbar stärkste Rechtsposition"); and Schütze "Einstweilige Verfügungen und Arreste im internationalen Rechtsverkehr, insbesondere im Zusammenhang mit der Inanspruchnahme von Bankgarantien" 1980 *WM* 1438 ("für den Auftraggeber ein Damokles-Schwert bei ungerechtfertigter Inanspruchnahme").

[131] See, for example, Wood (n 67) 371-372 par 20-017.

[132] Contrary to letters of credit, demand guarantees often only require a simple demand in writing by the beneficiary to trigger payment (see par 3.4.3.2 below).

[133] See par 3.4.2.1 above.

[134] See, for instance, the case of *Guardrisk Insurance Company Ltd v Kentz (Pty) Ltd* [2014] 1 All SA 307 (SCA), as discussed below (par 5.2.5).

[135] There is an increasing readiness noticeable in academic writing to change the established view that there is only one exception to the independence principle. See Hugo (n 38) 162; Enonchong (n 20) 94 par 4.64; and Mugasha "Enjoining the beneficiary's claim on a letter of credit or bank guarantee" 2004 *The Journal of Business Law* 515 537-538. A more in-depth discussion is presented in chapter 5 below.

[136] Bertrams (n 11) 372 par 14-17; Van Niekerk and Schulze (n 10) 291 par 3.9.3.1; Wilmot-Smith (n 76) 17 par 09.32; Kurkela (n 46) 173 ("The fraud exception is globally well-established"); Gao "Presenters immune from the fraud rule in the law of letters of credit" 2002 *LMCLQ* 10 ("The fraud rule in the law governing letters of credit is widely recognized in many countries"); and Horn (n 130) 2157 ("eine Ausnahme wird aber auch hier bei betrügerischen Lieferungen völlig wertloser Ware gemacht. Dies ist auch international anerkannt" – Horn's footnotes omitted).

[137] Enonchong (n 94) 405; Dixon (n 72) 396; Hugo (n 1) 271 par 6 3 2; Coleman (n 46) 234; while Gao (n 27) 39 called the case both "[t]he [c]atalyst" (alterations by me) and "the landmark case in the course of the development of the fraud rule in the law of letters of credit". For the law on letters of credit in England, the

exception back to the early American decision in *Sztejn v J Henry Schroder Banking Corporation,*[138] which arose in a letter-of-credit context. In this case, the seller shipped "worthless rubbish"[139] instead of the promised goods, but before the seller who was also the beneficiary under a letter of credit could demand payment from the bank, the misconduct became known to all parties. The question then arose whether the bank could be injuncted from honouring the documentary credit on the grounds that the consignment consisted only of entirely worthless material which was shipped fraudulently. Shientag J held that "intentional fraud on the part of the seller" had to be distinguished from ordinary underlying disputes concerning mere breach of contract and allegations of lack of quality and the like.[140] While he acknowledged the independence of the bank's undertaking to pay under the letter of credit largely irrespective of underlying disputes as between the seller and the buyer, he found that cases amounting to "active fraud"[141] ought to be distinguished. Therefore, he allowed the independence principle to be disregarded in situations of clear fraud. The fraud exception was subsequently adopted widely in common-law systems also in regard to demand guarantees.[142]

The position in German law is similar, although cases of fraudulent conduct are dealt with using the principle of *Rechtsmissbrauch* or *Rechtsmissbrauchsverbot* (abuse of rights, and prohibition of abuse of rights respectively).[143] The doctrine of *Rechtsmissbrauch* is dealt

case of *United City Merchants (Investments) Ltd v Royal Bank of Canada (The American Accord)* [1983] 1 AC 168 is also (additionally) mentioned very often. See Dixon (n 72) 396-397; and Hugo at 272 ("undoubtedly" the "leading English case on the fraud defence"). However, see also the remark in Bridge *Benjamin's Sale of Goods* (2014) 2210 par 24-022 n 75. Interestingly, the German *Reichsgericht,* then the highest court in civil matters in Germany, as early as 1923 held that "malicious conduct" ("arglistige[s] Verhalten", alteration by me) by the beneficiary allows the bank to reject the demand for payment. See RG *RGZ* 106, 304 308.

[138] *Sztejn v J Henry Schroder Banking Corporation* 31 NYS 2d 631 (1941) (Supreme Court New York County Special Term).

[139] at 633.

[140] at 634.

[141] at 635.

[142] Bertrams (n 11) 364-372; and Graf von Westphalen and Zöchling-Jud (n 26) 627-628 par 87-94. See the discussion in par 5.2 *et seq* below.

[143] Blesch, Meyer and Steinwachs (n 42) 123 par 518; Hök (n 12) 565 par 23; Blesch and Lange *Bankgeschäfte mit Auslandsbezug* (2007) 228 *et seq*; and Mülbert "Neueste Entwicklungen des materiellen Rechts der Garantie 'auf erstes Anfordern'" 1985 *Zeitschrift für Wirtschaftsrecht* (*ZIP)* 1101 1108-1111.

with in detail below.[144] The fraud exception has also been recognised clearly in South African law.[145] In *Guardrisk v Kentz,* Theron JA explained:

> "It is trite that where a beneficiary who makes a call on a [demand] guarantee does so with the 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."[146]

Although, broadly speaking, the fraud exception is well-entrenched internationally, the precise basis of the exception and the definition of exactly what constitutes "fraud", and "who" has to perpetrate or be privy to it, whether it must lie in the demand or the document or whether fraud in the underlying transaction is sufficient, and so forth, is less clear.[147] These are complex questions which have led to the well-founded remark of Xiang and Buckley, that "[t]he fraud rule is the 'most controversial and confused area' in the law governing letters of credit, mainly because the standard of fraud is hard to define."[148]

Naturally, due to the similar approaches in the law relating to letters of credit and demand guarantees, this comment is equally applicable to demand guarantees. These issues are explored in detail below.[149]

Regarding the regulatory instruments it is of interest to note that the UCP do not make any reference to the fraud exception. The intention is clearly to leave it to the domestic law of the different jurisdictions to work out.[150] The same applies to the URDG 758.[151] A similar legal stance was adopted – expressly so – in the ISP98. Rule 1.05(c) reads: "These Rules do not define or otherwise provide for: […] (c) defenses to honour based on fraud, abuse, or

[144] par 5.2.9 below.

[145] *First Rand Bank v Brera* (n 69) par 11 (per Malan JA); *Loomcraft Fabrics CC v Nedbank Ltd* (n 100); and *Phillips v Standard Bank of South Africa Ltd* 1985 (3) SA 301 (W). See further Hugo (n 38) 161; and Kelly-Louw "Limiting exceptions to the autonomy principle of demand guarantees and letters of credit" in Visser and Pretorius *Essays in Honour of Frans Malan* (2014) 197 200 and 201 (see especially her n 29 for abundant judicial authorities).

[146] *Guardrisk Insurance Company Ltd v Kentz (Pty) Ltd* (n 134) par 17 (per Theron JA, insertion by me).

[147] Antoniou (n 95) 231; and Bertrams (n 11) 372 par 14-17 (see further his comparative analysis regarding several European countries and the United States at 355-376); Dixon (n 72) 397; and Gao (n 27) 56-57.

[148] Xiang and Buckley "A comparative analysis of the standard of fraud required under the fraud rule in letter of credit law" 2003 *Duke Journal of Comparative and International Law* 293 333 (insertion by me, their footnote omitted).

[149] par 5.2 *et seq* below.

[150] Ryder, Griffiths and Singh (n 12) 224 par d; Enonchong (n 20) 96 par 5.03; Ellinger and Neo (n 82) 139; Gao (n 27) 56-57; and Kaya (n 1) 54 par 2.

[151] Schütze and Edelmann (n 46) 114 par VI; Bridge (n 137) 2210-2211 par 24-022; Enonchong (n 20) 96 par 5.03; and Gao (n 27) 58.

similar matters. These matters are left to [the] applicable law."[152] This stands in contrast to the UNCITRAL Convention which provides a reasonably comprehensive framework for the fraud exception (and other potential exceptions).[153] This, too, is dealt with in more detail below.

Other exceptions

In some legal systems other exceptions, or potential exceptions, to the independence principle have also emerged.[154] These include the illegality of the underlying transaction, the final determination of the dispute in the underlying transaction, and the fact that the demand may be regarded as being unconscionable. These issues, and the extent to which they may be regarded as exceptions to the independence principle, are dealt with in detail below.[155] Moreover, some underlying contracts between the applicant and beneficiary may contain clauses[156] restricting the beneficiary's entitlement to call upon the guarantee. Whether the applicant can enforce such a restrictive stipulation (so-called *negative stipulation*)[157] is considered below. Even though the enforcement of such negative stipulations does probably not amount to a true exception to the independence principle, it is nevertheless linked to the broader issue of abusive calls on demand guarantees.

3.4.2.6 Restraining a call on the guarantee: procedural aspects and injunctions

The question of how an abusive demand on a guarantee can be challenged, and what legal remedy may be available to the applicant, is also dependent on procedural aspects.[158] Many

[152] ISP98 rule 1.05 (insertion and alteration by me, italics omitted). See further Lienesch (n 10) 13 who remarks on the general reluctance of international rules to incorporate a fraud definition.

[153] See articles 19 and 20. See further Enonchong (n 20) 96 par 5.03; Bertrams (n 11) 376-377; and Gao (n 27) 60-63.

[154] See, for instance, the instructive article by Lurie (n 72) 443 *et seq*; and Hugo (n 42) 451 *et seq*.

[155] See par 5.3 *et seq* below.

[156] In this regard the German notion of so-called *Nebenpflichten* is of importance as they may also restrict the beneficiary. For a discussion see par 7.4 below.

[157] For an in-depth discussion see par 7.1 *et seq* below.

[158] A full discussion on procedural aspects relating to (interim) court relief in cases of abusive calls on demand guarantees falls outside the scope of this thesis. This paragraph seeks only to introduce the basic aspects in this regard from a South African, English and German perspective. See also par 8.5 below.

jurisdictions, therefore, allow judicial intervention in situations of abuse and fraud.[159] Objections to a demand for payment based on allegations of serious abuse can be raised, typically, at two stages: (i) when a demand is made or is anticipated but before payment has been effected; or (ii) after payment has been made at the reimbursement/final accounting stage (between the applicant and guarantor in accordance with the contract of mandate, or between the applicant and the beneficiary as a final accounting exercise).[160] Raising objections to the legitimacy of the demand before payment is made has the advantage that money does not change hands if the challenge is successful. Subsequent insolvency of the beneficiary and other legal problems relating to recovery actions can be avoided. On the other hand, the independence principle could be seen as infringed upon if court relief is sought successfully. Therefore, judicial interference must be kept to a minimum and only be allowed in cases of clear and blatant abuse which merit immediate redress.[161] Moreover, it is suggested that it may be desirable and more promising to apply for court relief against the beneficiary, and not against the guarantor.[162] If relief is granted by the court against the beneficiary, this will prevent the beneficiary from calling up the guarantee and the dispute over entitlement to payment would be kept between the applicant and the beneficiary. The involvement of the guarantor could be avoided. This way, the independence principle would be protected and respected as much as possible.[163]

The law of South Africa offers a procedural remedy, the prohibitory interdict,[164] which can be applied for in order to prevent a beneficiary from demanding payment or a guarantor making payment. Such an interdict can either be a final or an interim court order. A final interdict, if granted, prohibits the beneficiary from calling up the guarantee

[159] Kelly-Louw "International measures to prohibit fraudulent calls on demand guarantees and standby letters of credit" 2010 *George Mason Journal of International Commercial Law* 74 114.

[160] See par 3.3 above.

[161] See par 3.4.2.4 ("pay first, argue later") above.

[162] Blesch and Lange (n 143) 178 par 585; Derleder, Knops and Bamberger *Handbuch zum deutschen und europäischen Bankrecht* (2009) 1879-1880 par 89-90; Dunham (n 124) 285; Bertrams (n 11) 446 (with special regard to English and German law); Nielsen "Rechtsmißbrauch bei der Inanspruchnahme von Bankgarantien als typisches Problem der Liquiditätsfunktion abstrakter Zahlungsversprechen" 1982 *Zeitschrift für Wirtschaftsrecht und Insolvenzpraxis* (*ZIP)* 253 262; Kelly-Louw (n 44) 420 par 7.4.3; and Hugo (n 1) 268 and 329. See also *Loomcraft Fabrics CC v Nedbank Ltd* (n 100) at 816. See further Mugasha (n 135) 527.

[163] However, note the view expressed in Enonchong (n 20) 230-233.

[164] Loggerenberg *Erasmus: Superior Court Practice Volume II* (2016) par D6-3 a.

permanently.[165] It requires the applicant to prove that it has a clear right, suffered an injury or reasonably expects an injury, and the lack of other procedural remedies offering adequate protection.[166] An interlocutory or interim interdict is a provisional court measure which prevents a person from doing something (calling up or making payment in the case of abuse of a demand guarantee) for a specified period of time unless such a temporary order is made final.[167] In order to apply for such an interim interdict the applicant would have to show a *prima facie* right, apprehension of serious injury if the interim relief is denied and the ultimate relief is eventually granted, the passing of a balance of convenience test, and the absence of alternative adequate remedies.[168]

English law recognises a similar procedural remedy known as a prohibitory injunction.[169] Such an injunction can prevent the beneficiary from presenting a demand based on strong allegations of fraud and other forms of serious abuse, or the guarantor from accommodating such a demand.[170] The applicant must supply convincing and clear evidence of the abuse and satisfy a balance of convenience test.[171]

Both English and South African law also recognise an anti-dissipation order (the so-called Mareva or freezing injunction in English law, and the anti-dissipation interdict in South African law) which can be granted against the beneficiary.[172] While this order does not prevent the actual call on the guarantee, it would instruct the beneficiary to refrain from

[165] Loggerenberg (n 164); and Prest *The Law and Practice of Interdicts* (2014) 42.

[166] Loggerenberg (n 164) par D6-12; Prest (n 165) 42 *et seq*; and Harms *Civil Procedure in the Superior Courts* (2003) 27 par A5.2.

[167] Harms (n 166) 26 par A5.1 and 28 par A5.6.

[168] *Setlogelo v Setlogelo* 1914 AD 221; Loggerenberg (n 164) par D6-17; Prest (n 165) 49 *et seq*; Kelly-Louw (n 44) 417-418; and Harms (n 166) 29 par A5.7.

[169] Beale *Chitty on Contracts Volume I General Principles* (2012) 1945 par 27-060; Bailey *Construction Law Volume III* (2011) 1800 par 26.127; Furst and Ramsey (n 82) 424; Hill and Chong *International Commercial Disputes* (2010) 339 par 10.1.6; and Heidbüchel (n 1) 284.

[170] *Themehelp Ltd v West* [1996] QB 84 (CA); and Enonchong (n 20) 227 *et seq* for a very instructive analysis in this regard. See also Bailey (n 73) 930; Wood (n 67) 373 *et seq*; and Adams "New clots in the life-blood of international construction projects: enjoining employers' calls on performance bonds" 2014 *Construction Law Journal* 325.

[171] *American Cyanamid Co v Ethicon Ltd* [1975] 1 All ER 504 (HL); Bertrams (n 11) 432 par 16-2 and 436-439; Davis (n 38) 133-134; Kelly-Louw (n 44) 385-386; and Heidbüchel (n 1) 285-286.

[172] Enonchong (n 20) 252 *et seq*; Chambers (n 128) 1346-1347; Bailey (n 169) 1817 par 26.162; Malek and Quest (n 15) 294 *et seq*; Mugasha (n 94) 171-174; Hill and Chong (n 169) 340 par 10.1.8; Harms (n 166) 33 par A5.18; Kelly-Louw (n 44) 426 par 7.4.5; and Hugo (n 1) 320. A similar court measure is available in German law (*Arrest*). See Graf von Westphalen and Zöchling-Jud (n 26) 340 *et seq*; and Buch *UN-Konvention über unabhängige Garantien und Stand-by Letters of Credit* (2000 thesis Heidelberg) 270 *et seq*.

moving the proceeds of the guarantee abroad or otherwise "beyond the reach of the applicant".[173]

It must be emphasised, however, that applications for interim court relief under English and South African law in cases of applications relating to independent guarantees require reasonably strong *prima facie* cases and convincing allegations of serious abusive conduct on the part of the beneficiary, and that such relief will not be granted regularly but only in exceptional circumstances.[174] These limitations on the availability of judicial intervention are a consequence of the independence principle and the notion that objections to the demand for payment should generally be argued out between applicant and beneficiary after payment has been received.[175]

In German law, an applicant is advised to direct its actions for interim relief ("Einstweilige Verfügung")[176] primarily against the beneficiary.[177] This view appreciates the fact that some courts in Germany have declined, or made it more difficult to obtain, interim relief against the guarantor.[178] The applicant is required to furnish clear and immediate proof of the alleged abuse (*Rechtsmissbrauch*),[179] ideally in the form of documentary proof.[180] Therefore, German law, in line with the position in English and South African law, imposes a

[173] Kelly-Louw (n 44) 427. See also Davis (n 38) 137 par 19.37; and Bertrams (n 11) 481 par 17-9.

[174] *National Infrastructure Development Co Ltd v PNB Paribas* [2016] EWHC 2508 (Comm) (par 15); *United Trading Corporation SA v Allied Arab Bank Ltd* [1985] 2 Lloyd's Rep 554; *Guardrisk Insurance Company Ltd v Kentz (Pty) Ltd* (n 134) (par 18, 28-29); *Hollard Insurance Co Ltd v Jeany Industrial Holdings (Pty) Ltd* [2016] ZAGPJHC 175 (24 June 2016) (par 27 per Mashile J: "Payment may only be refused in the most perfect cases of fraud. In the absence of an allegation that payment was demanded fraudulently and in bad faith, payment must be made."); Enonchong (n 95) 85-87; Davis (n 38) 130-131 par 19.6; Malek and Quest (n 15) 28 *et seq*; Crangle "Resistance is futile? Performance bonds and how payment under them can be stopped" (presentation at the Society of Construction Law conference, Leeds 13 March 2012) 5 ("difficult test to meet", "high test"); Kelly-Louw (n 44) 333-334 and 420; and Hugo (n 1) 278. See also *Loomcraft Fabrics CC v Nedbank Ltd* (n 100) at 816.

[175] See par 3.4.2.4 above.

[176] Schütze and Edelmann (n 46) 148 *et seq* recommend, however, a different form of interim relief (so-called *Arrest*).

[177] Blesch and Lange (n 143) 177 par 582; Derleder, Knops and Bamberger (n 162) 1879 par 89; Heidbüchel (n 1) 273 *et seq*; and Schütze (n 130) 1438. Additionally, the remedy of *Arrest* against the beneficiary may be available too. See Graf von Westphalen and Zöchling-Jud (n 26) 340 *et seq*; Schütze and Edelmann (n 46) 148-152; and Buch (n 172) 270 *et seq*.

[178] OLG Cologne 1991 *WM* 1751; OLG Frankfurt 1988 *WM* 1480; and OLG Stuttgart 1981 *WM* 631. See Buch (n 172) 258 *et seq*.

[179] The concept of *Rechtsmissbrauch* is examined in detail below (par 5.2.9).

[180] Graf von Westphalen and Zöchling-Jud (n 26) 202 par 200 and 312 par 14; Jedzig "Aktuelle Rechtsfragen der Bankgarantie auf erstes Anfordern" 1988 *WM* 1469 1673 par 3.2; Nielsen (n 162) 260; and Edelmann "Blockierung der Inanspruchnahme einer direkten Auslandsgarantie" 1998 *Der Betrieb* (*DB)* 2453.

reasonably high threshold for the application for interim relief in demand guarantee cases, so as to preserve the independent nature of the instrument as far as reasonably possible.

Similarly, the UNCITRAL Convention[181] also provides for interim court measures available to an applicant in specific cases of serious abuse of the guarantee by the beneficiary.[182]

3.4.2.7 Conclusions

Gao remarks that "good commercial law is one that serves commerce best. A law that serves commerce best maximises certainty and predictability for the commercial community".[183] This comment elevates the value of legal certainty, which in turn strongly supports the independence principle in demand guarantees. The assurance of being able to convert a demand guarantee swiftly into money, however, cannot be limitless, as this would open the door to unacceptable cases of injustice in certain circumstances.[184] Hence, legal certainty must be balanced against the legitimate interests of the applicant that are worthy of the protection of the law.[185] Notions of fairness, equity, reasonableness, justice, public order and public policy may all be relevant in this regard.[186] With this in mind, in exceptional cases of abusive calls on the demand guarantee the independence principle could be infringed upon to allow objections and arguments, arising from the underlying contract between applicant and beneficiary, in relation to the obligation of the guarantor under the instrument. This area of law is controversial and much-debated in legal writing and jurisprudence. It is revisited in detail in this thesis below, especially in Chapter Five.

[181] See par 3.2.3 above.

[182] Articles 19-20. Kelly-Louw (n 159) 105-116; De Ly (n 10) 842-844; Gao (n 10) 67-71; Buch (n 172) 399 *et seq*; and Ellinger and Neo (n 82) 351.

[183] Gao (n 27) 57.

[184] Enonchong (n 20) 93 par 4.61; further Kurkela (n 46) 103 *et seq*; and Horn (n 130) 2156 par III 3.

[185] In this regard, Enonchong (n 20) 2-3 par 1.03-1.05 speaks of "balancing two conflicting interests". See also Wood (n 67) 374 par 20-021; and Wilmot-Smith (n 76) 197 par 9.32 ("it is a risk of unfairness which is bargained for commercially").

[186] See for instance Hugo (n 38) 161; Gao (n 27) 30; Enonchong (n 20) 93 par 4.62 (note that he mentions "public interest" and the "illegality exception" as considerations not directly serving the applicant's interest, but rather the general public); Kurkela (n 46) 181; and Loots *Construction Law and Related Issues* (1995) 654.

3.4.3 Principle of documentary compliance

3.4.3.1 Introduction

The second important principle in the law of demand guarantees and letters of credit is known as the doctrine of "documentary compliance" or "strict compliance" (in German law "Dokumentenstrenge").[187] The principle of documentary compliance entails that in calling up the guarantee, the beneficiary must comply with all formal requirements prescribed in the instrument itself.[188] The tendered documents must comply with the conditions set forth in the instrument, and any discrepancy may lead to the guarantor rejecting the demand and denying payment.[189] Hence, Fourie AJA in *State Bank of India v Denel SOC Limited* stated:

> "A bank issuing an on demand guarantee is only obliged to pay where a demand meets the terms of the guarantee. Such a demand, which complies with the terms of the guarantee, provides conclusive evidence that payment is due."[190]

Conversely, the beneficiary will be able to know exactly what is required for the triggering of payment under the instrument. The term "documentary compliance" emphasises a further important general rule regarding the requirements to be met for payment under a guarantee, namely that they are (typically) documentary in nature. In other words, whatever conditions need to be met by the beneficiary, they are typically tied to the presentation of some or other document.[191] This principle emerges clearly from the URDG 758 which put it thus: "Guarantors deal with documents and not with goods, services or performance to which the documents may relate".[192] Similarly, the ISP98 stipulates that "[a] standby is an irrevocable, independent, documentary and binding undertaking" and continues to explain that "[b]ecause a standby is documentary, an issuer's obligation depends on the presentation of documents

[187] BGH *BGHZ* 145 286 293; Graf von Westphalen and Zöchling-Jud (n 26) 189 par 177 *et seq*; Bertrams (n 11) 136-146 par 10-19 *et seq*; Kelly-Louw (n 44) 72 par 2.5.2.5 *et seq* and 89 par 2.5.2.5.4 *et seq*; Ellinger and Neo (n 82) 117 *et seq* and 224 *et seq*; and Wood (n 67) 372-373 par 20-019.

[188] Again, this shows how important it is to draft a demand guarantee properly. See in this regard Zozaya Irujo "Trade Finance and the Banking Commission of the ICC" 2016 *Annual Banking Law Update* 71 72 *et seq*. The drafting of the guarantee is dealt with in par 8.3 below.

[189] Bernhardt (n 46) 67-68 (with several references and sources in support); and Ellinger and Neo (n 82) 227 par B. However, see also Kelly-Louw (n 44) 73 *et seq*; and BGH (n 187) 293 ("Einer wörtlichen Übereinstimmung mit dem Urkundeninhalt, wie sie die Revision hier für erforderlich halt, bedarf es indes nur, wenn das ausdrücklich vereinbart wurde").

[190] *State Bank of India v Denel SOC Limited* (n 68) at 9.

[191] Note that Kelly-Louw (n 44) 64 seems to regard the issue of "documentary" requirements as belonging to the principle of independence, and not to the doctrine of compliance.

[192] URDG 758 Art6. See also UCP 600 Art5.

and an examination of required documents on their face".[193] The URDG, moreover, provides that non-documentary conditions will be deemed "as not stated" by guarantors,[194] and the ISP98 that they "must be disregarded".[195] Although these rules are of no assistance in instances where the guarantee has not been issued subject to them, they are clearly indicative of reticence in the guarantee industry of issuing guarantees containing such non-documentary conditions.

In the construction context the documents required are often one or more of the following: a written notice demanding payment of the specified amount; a written statement asserting the applicant's breach of contract (sometimes specifying the extent thereof); the original copy of the demand guarantee itself;[196] a notice of cancellation of the underlying contract; a certificate or confirmation by an expert or surveyor to a certain fact (quality of product or service, amounts paid or outstanding and so on); a copy of a court order initiating the sequestration or liquidation of a particular party (for instance the applicant); and a judgment or arbitral award which confirms the breach of contract.[197] The choice of documents required is an important issue which may also impact upon the extent of independence ascribed by the parties to the guarantee,[198] and is a clear indication of their individual bargaining power. For example, requiring a judgment or arbitral award in favour of the beneficiary on the underlying contract undermines considerably the independence principle. Due to the time it may take for such a judgment or award to be made, the commercial value of the guarantee is weakened significantly. Bearing in mind that the very

[193] ISP98 rule 1.06 a) and d) (alteration by me).

[194] Article 7.

[195] Rule 4.11 (a).

[196] See, for instance, *Nedbank v Procprops* [2013] ZASCA 153 (20 November 2013). For a detailed discussion of this case see par 6.4 below.

[197] *East London Own Haven t/a Own Haven Housing Association v Coface South Africa Insurance Co Ltd* (n 100) (notice of cancellation); *First Rand Bank v Brera* (n 69) (payment certificate); *Maykent v Trackstar* [2015] ZASCA 14 (17 March 2015) (certificate of final completion); and *Compass Insurance v Hospitality Hotel Developments (Pty) Ltd* 2012 (2) SA 537 (SCA) (copy of court order which confirmed provisional liquidation). For a court order or arbitral award confirming breach of contract, see Andrews and Millett (n 46) 616. As previously explained, such a requirement which obliges the beneficiary to obtain a judgment or arbitral award confirming the breach of the underlying contract can be seen as very inconvenient and not in line with the notion of a certain and expedient way of effectively claiming monies under a demand guarantee. See the previous discussion of the URCG 325, par 3.2.1 above.

[198] See Goode "Abstract payment undertakings and the rules of the international chamber of commerce" 1995 *Saint Louis University Law Journal* 725 734; Horn (n 45) 144 par 523 ("Je nach Art und Inhalt des Dokuments ist die Rechtsposition des Garantieberechtigten unverändert stark oder stufenweise eingeschränkt"); as well as Davis (n 38) 8 par 2.33 and 9 par 2.37.

purpose of a demand guarantee is to provide an almost immediate, easy and certain way of making funds available, requiring such a document would seriously infringe the guarantee's commercial viability. This thinking is reflected in the development of provisions of the relevant rules of the ICC in this regard.[199]

A less extreme approach is to require a document in which the beneficiary provides details concerning the breach of contract by the applicant upon which the beneficiary is relying. This is the approach evident in article 15(a) of the URDG:

> "A demand under the guarantee shall be supported […] in any event by a statement, by the beneficiary, indicating in what respect the applicant is in breach of its obligations under the underlying relationship."[200]

This type of condition is less problematic since the document is executed by the beneficiary itself without third-party involvement.[201] From the applicant's perspective the advantage of this document is that the beneficiary must commit itself to a specific statement of the breach relied upon.[202] If this statement is patently untrue it may facilitate reliance by the applicant on the fraud exception.[203] The guarantee may also be so drafted as to require only a "bare demand" without further explanation, allegation or documents to trigger payment. Due to the ease with which such guarantees can be abused by beneficiaries they are sometimes referred to as "suicide" guarantees.[204]

[199] See par 3.2.1 above for the developments of these rules, the URCG 325, URDG 458, and the URDG 758.

[200] Omission and insertion by me.

[201] As opposed to, for example, a certificate by an expert or a court order which naturally requires the services of third-parties. Note, however, the criticism in Graf von Westphalen and Zöchling-Jud (n 26) 380 par 20 who argue that such a requirement does not align or correspond with a guarantee payable on first demand ("Dieses Erfordernis steht quer zu einer Garantie, welche auf 'erstes' Anfordern zahlbar gestellt ist").

[202] See Blesch and Lange (n 143) 135-136 par 514-515. Coleman (n 46) 229, however, is rather sceptical and assumes that the only benefit of having to state that a breach of contract occurred to be "the psychological burden on a beneficiary who is making a false claim".

[203] See the remarks by Hugo (n 38) 164 (first sentence), as well as Mugasha (n 94) 175-176. Graf von Westphalen (n 31) 2021 par b) with critical remarks ("Nur in dieser 'schriftlichen Lüge' liegt der Vorteil der 'Demand Guarantees'"). Although his elaborations refer to the former URDG 458, it is equally applicable to the contemporary URDG 758. See also Graf von Westphalen (n 82) 330, where he also questioned the merit of such a provision for protecting the guarantor and/or applicant; as well as Bridge (n 137) 2234-2235 par 24-068; Ehrlich and Haas (n 84) 405 par 9/21; and Enonchong (n 20) 89 par 4.54 (first sentence).

[204] Enonchong (n 20) 144 par 5.127; and Horn and Wymeersch *Bank-Guarantees, Standby Letters of Credit and Performance Bonds in International Trade* (1990) 8 par b. See also Bailey (n 73) 917 par 12.53 n145.

3.4.3.2 Relevance and applicability of the doctrine of documentary compliance

It is sometimes said that the principle of documentary or strict compliance is of greater importance to letters of credit than to demand guarantees.[205] This observation relates to the fact that in some cases a demand guarantee may require only a written demand (perhaps together with a statement by the beneficiary alleging breach of contract on the part of the applicant).[206] In letter-of-credit cases, on the other hand, a whole array of documents is typically to be tendered in order to trigger payment (such as bills of lading or other transport documents, insurance policies, commercial invoices, packing lists, quality or quantity certificates).[207] The number and complexity of the documents raise the importance of their conformity.[208] Moreover, and possibly more importantly, these documents usually "relate to […] merchandise and have an intrinsic commercial value, whereas any documents presented under a guarantee relate to the applicant's non-performance and do not have any intrinsic value."[209] Although there may be merit in these views they must not be overemphasised. As is apparent from the case law relating to guarantees considered below,[210] the compliance of the demand is undoubtedly crucial also in this part of the law.

3.4.3.3 Non-documentary conditions

Despite the generally accepted approach in letters of credit and guarantees that they are "documentary" in nature,[211] sometimes they are not so drafted and non-documentary

[205] See, for instance, Chambers (n 128) 1339 par 10-060; Wood (n 67) 386 par 21-009; and *Kristabel Developments (Pty) Ltd v Credit Guarantee Insurance Corporation of Africa Limited* [2015] ZAGPJHC 264 (20 October 2015), especially par 19 *et seq*.

[206] See par 5.2.6 below.

[207] Murray, Holloway and Timson-Hunt *Schmitthoff The Law and Practice of International Trade* (2012) 145 par 7-004; Enonchong (n 20) 33 par.3.13; Mankowski "Transport documents" in Basedow, Hopt, Zimmermann and Stier *The Max Planck Encyclopedia of European Private Law Volume II* (2012) 1690 1692 par 7; Proctor (n 55) 498-499 par 24.34-24.40; and Schütze (n 47) 86 *et seq*.

[208] For the question as to the "strictness" of the compliance of the documents under letters of credit as opposed to demand guarantees from a South African point of view, see *Kristabel Developments (Pty) Ltd v Credit Guarantee Insurance Corporation of Africa Limited* (n 205) par 19 *et seq*. Regards may also be had to the discussion in Enonchong (n 20) 82 par 4.40 *et seq*; and also Debattista (n 28) 300-301.

[209] Bertrams (n 11) 68 par 5-3 (insertion and omission by me); see also Enonchong (n 20) 34 par 3.14; Proctor (n 55) 501 par 24.49-24.50; and Fedotov "Abuse, unconscionability and demand guarantees: new exception to independence" 2008 *International Trade and Business Law Review* 49 58.

[210] See par 6.2 *et seq* below.

[211] Some scholars even regard the "documentary" nature of requirements in demand guarantees and letters of credit as a separate third principle to be recognised in addition to the two established principles of (i) independence and (ii) strict compliance: see Mugasha (n 94) 23.

conditions emerge.[212] Such a non-documentary condition could, for instance, be of the effect that the beneficiary must ship on a vessel belonging to owners who are associated with a particular shipping conference, but without making provisions for a particular document from which this is evident.[213] Such non-documentary conditions, it is submitted, clearly run counter to legal certainty, which is so important in letter-of-credit and guarantee transactions.

To borrow from the URDG 758: "Guarantors deal with documents and not with goods, services or performance […]".[214] Bertrams summarised it thus: "Banks cannot properly function if they are compelled to investigate and verify facts. They can only deal with documents."[215] Therefore, requiring the guarantor to investigate beyond the documents in order to determine whether a call under a demand guarantee has any merits would lead to lengthy and unintended procedures for which banks are generally not equipped.[216] Investigations beyond the documents further hold the danger of infringement upon the independence principle. Moreover, Malek and Quest argue convincingly that non-documentary conditions will often have a significant negative impact upon time within which the issuer is able to determine whether it must pay.[217] Finally, in this regard, the use of a non-documentary condition leads to an inherent conflict if the instrument concerned is subject to the UCP or URDG (in terms of which such conditions are to be disregarded). The question is whether the (specific) express non-documentary condition may not override the (general) express inclusion of the rules in question.[218]

[212] McKendrick (n 16) 1083; and Kelly-Louw (n 44) 65.

[213] Ellinger and Neo (n 82) 238; and McKendrick (n 16) 1083, both with reference to the case(s) of *Banque de l'Indochine et de Suez SA v JH Rayner (Mincing Lane) Ltd* [1983] QB 711 and [1982] 2 Lloyd's Rep 476, respectively.

[214] URDG 758 Art6 (omission and insertion by me).

[215] Bertrams (n 11) 31 par 2-14.

[216] In this regard Hugo (n 1) 122 par 3 9 3 points out that "[t]he problem with conditions of this nature is that they may draw the bank into the underlying contract between the applicant for the credit and the beneficiary" (alteration by me).

[217] Malek and Quest (n 15) 113-114 par 5.59-5.60 and 181 par 8.26. Their statement refers to the UCP 600 (Art16 c) and d)) and its prescribed period of examination and possible rejection within a maximum of five days after a presentation has been made by the beneficiary; the URDG 758, incidentally, contain a similar provision in Art20 a.

[218] Malek and Quest (n 15) 179-181 par 8.23-8.25; McKendrick (n 16) 1083; and Ellinger and Neo (n 82) 239. Further, see UCP 600 Art14 h), URDG 758 Art7 and ISP98 rule 4.11. For purposes of this thesis, however, an in-depth discussion of this particular issue is not necessary.

3.5 General concluding remarks and analysis

Demand guarantees and letters of credit share structural properties and follow similar principles,[219] as mentioned above. This is true especially in regard to the principle of independence[220] – but there are important considerations to be borne in mind which are of relevance to the question of abusive calls on such instruments. As Bertrams[221] warned, "[…] one must be careful not to adopt each and every rule relating to letters of credit mechanically and without reflection". First, a claim under a letter of credit is triggered by the beneficiary submitting documents relating to the *due performance* of the underlying contract.[222] The position under a demand guarantee is quite different. Here payment can be requested in opposite cases, that is where performance[223] was *not* rendered satisfactorily.[224] As such, letters of credit and demand guarantees have been described as "psychological opposites".[225] Secondly, and connected to the first point, the beneficiary's calling for payment under a letter of credit is a regular occurrence and is actually expected by all parties concerned.[226] This stems from the letter of credit's primary "payment function" in (international) trade.[227] As

[219] Enonchong (n 20) 32-33 par 3.10-3.11; Wilmot-Smith (n 76) 193-194 par 9.20; Dixon (n 72) 395 *et seq*; and Gao (n 27) 8.

[220] See Bertrams (n 11) 67; and Kurkela (n 46) 102-103. But see also the rather bold statement, it is respectfully submitted, by Debattista (n 28) 303 ("The principle of autonomy is commercially justifiable in the letter of credit, but totally without such foundation in performance bonds").

[221] Bertrams (n 11) 67 par 5-3 (insertion and omission by me). See also Dixon (n 72) 395.

[222] Enonchong (n 20) 33 par 3.12-3.13; and Richter (n 1) 84. Note, however, that these documents – although compliant under the letter of credit – need *not* necessarily establish that due performance of the contract has *in fact* been rendered. One could, for instance, think of scenarios where the quality of the goods represented by the documents later turns out to be inferior and insufficient. In this regard, see Gao (n 27) 7. Nevertheless, for the discussion at hand, it is sufficient to accept the idea that complying documents in a letter-of-credit transaction indicate due performance of the underlying obligations by the beneficiary.

[223] It is important to note that "performance" in this regard may relate to any obligation or simply the occurrence of an event as described in the demand guarantee itself. That could be, for example, the repayment of an advance payment, the maintenance of a factory, the completion of a building, or the insolvency of a contract party; see Kurkela (n 46) 15-16. Therefore, Malan JA, in a judgment handed down by the South African Supreme Court of Appeal, referred to "the happening of a specified event" when elaborating on this point; see *First Rand Bank v Brera* (n 69) par 2.

[224] Carr (n 49) 470; Fedotov (n 209) 58-59; Enonchong (n 20) 33 par 3.12; Gao (n 27) 7; Richter (n 1) 84 (though the remarks by Gao and Richter refer to standby letters of credit they are equally appropriate in regard to demand guarantees owing to their similar structures); and Affaki (n 76) 135 par 192.

[225] Harfield "The increasing domestic use of the letter of credit" 1971/1972 *Uniform Commercial Code Law Journal* 251 258 par Conclusion. Although Harfield's article referred to standby letters of credit, his expression is equally fitting for the case of demand guarantees.

[226] Gao (n 27) 6-7; Heidbüchel (n 1) 17; and Mahler *Rechtsmißbrauch und einstweiliger Rechtsschutz bei Dokumentenakkreditiv und 'Akkreditiven auf erstes Anfordern'* (1986) 14.

[227] Enonchong (n 20) 33 par 3.12; Apathy, Iro and Koziol (n 9) 10 par 1/11 (but note also their remarks towards the end of par 1/11); Graf von Bernstorff and Altmann (n 55) 3; and Mahler (n 226) 9.

Ellinger and Neo explain, "[i]n a commercial letter of credit, the parties intend that the seller should look, in the first instance, to the issuing bank rather than the buyer when he seeks payment for the goods."[228] Therefore, the bank that issued a letter of credit is considered to be "the first port of call for payment".[229]

Demand guarantees, on the other hand, serve mostly a security function and are neither intended to, nor do they act as a regular means of facilitating payment.[230] Kelly-Louw describes the demand guarantee as "secondary in intent but primary in form".[231] Thus, "an independent guarantee is usually intended to be activated only if the applicant has failed to perform his obligations in the underlying contract".[232] Accordingly, calls under such independent guarantees are "still rather a rare event", as Lehtinen[233] reports, because they only occur when the contractual relationship between applicant and beneficiary experiences difficulties. This must be taken into account when contemplating the issue of abusive calls of independent instruments like letters of credit as opposed to demand guarantees, especially in light of possible exceptions to the independence principle.[234] Interfering with the payment of a letter of credit, that is allowing exceptions to the principle of independence, may deprive a beneficiary of all the payment assurance and security that it holds, whereas legal intervention into a demand-guarantee transaction, on the grounds of a beneficiary's abusive behaviour, may, comparatively, be less invasive.[235] This issue, however, is complex and is considered in more detail below.[236]

[228] Ellinger and Neo (n 82) 308 (alteration by me).

[229] McKendrick (n 16) 1055 and 1129.

[230] Bernhardt (n 46) 20 par b); Ellinger and Neo (n 82) 308; Apathy, Iro and Koziol (n 9) 12 par 1/14, 226 par 3/3 and 257 par 3/50; Blesch and Lange (n 143) 129-130 par 504; Loh and Wu (n 86) 352 *et seq*; Yang *The Law of Guarantees in Singapore and Malaysia* (1992) 47 par b; and Heinze *Der einstweilige Rechtschutz im Zahlungsverkehr der Banken* (1984) 141 par 1.

[231] Kelly-Louw (n 44) 51 par 2.5.1.3 (italics omitted).

[232] Ellinger and Neo (n 82) 308.

[233] Lehtinen "Demand guarantees in construction contracts: the Finnish perspective" 2010 *The International Construction Law Review* 511.

[234] See par 5.2 *et seq* below.

[235] See, for instance, Crangle (n 174) 13.

[236] See par 5.2 *et seq*, especially par 5.2.6, below.

Chapter Four: Demand guarantees in the construction industry

4.1 Introduction

This chapter serves to link the general field of demand guarantees as a method to provide security in business transactions with specifically, their use in the construction industry. Against this background, the different types of guarantees encountered in construction are introduced and their particular application examined critically. Alternative instruments also serving a security function in the construction industry are considered and evaluated comparatively.

Given the numerous risks encountered in construction referred to above,[1] parties involved in this particular field of business need to ensure sufficient protection. Demand guarantees are a common feature of international commerce and construction contracts, and are used widely within the industry.[2] Over the years they have been employed in various construction contexts which have led to the establishment of several types of guarantees,[3] including performance guarantees, maintenance guarantees, tender guarantees, as well as payment, repayment and retention-money guarantees. While these different guarantees vary in that they cover different risks, they all retain the common foundation of independence and abstraction. It would be fair to say that their popularity and success within the construction setting can largely be ascribed to this feature.

[1] See par 3.1 above.

[2] Broccoli and Adams "On –demand bonds: a review of Italian and English decisions on fraudulent or abusive calling" 2015 *International Construction Law Review* 103 103-104; Van der Puil and Van Weele *International Contracting* (2014) 279 par 14.7; Hellner and Steuer *Bankrecht und Bankpraxis* (2006) par 5/231; Hök *Handbuch des internationalen und ausländischen Baurechts* (2012) 553 par 2; Wilmot-Smith *Construction Contracts Law and Practice* (2010) 194 par 9.21; Horowitz *Letters of Credit and Demand Guarantees* (2010) 2 par 1.06 ("Demand guarantees are also prolific in international commerce"); O'Donovan and Phillips *The Modern Contract of Guarantee* (2010) 907 par 13-72; Lurie "On-demand performance bonds: is fraud the only ground for restraining unfair calls?" 2008 *The International Construction Lawyer* 443; and Rodrigo "Toward fairness in the guarantee market: the rationale for expanding interventions from fraud to unconscionability in the enforcement of demand guarantees" 2013 *International Trade and Business Law Review* 225 (especially 225-226).

[3] See Brindle and Cox *Law of Bank Payments* (2010) 778 par 8-028 who write: "Demand bonds are commonly referred to by other names according to their purpose (for example, performance guarantees, performance bonds, advance payment bonds and tender bonds)".

4.2 Standard-form contracts and guarantees

Standard-form contracts, which are commonly used within the construction industry,[4] often contain provisions requiring the issuing of demand guarantees.[5] Further, some agencies and professional bodies include pro-forma demand guarantees in their suits of documents relating to the construction process. This enables the construction parties concerned to utilise and rely on guarantees drafted by construction professionals and members of the industry. In South Africa, for example, both the JBCC[6] and the GCC[7] offer standard-form demand guarantees designed for different purposes relating to construction.[8]

These standard-form guarantees allow parties to avoid the ad-hoc drafting of guarantees and facilitate the development of a body of interpretive jurisprudence relating to them.[9] In the international context, the FIDIC documents as well as the URDG contain standard-form demand guarantees.[10]

4.3 Types of demand guarantees in construction

4.3.1 Performance guarantee

The most common type of demand guarantee in the construction industry is probably the performance guarantee,[11] also referred to as a performance bond.[12] As the name suggests, this

[4] See par 2.6 above.

[5] JCT and FIDIC standard contracts, for instance, contain such clauses. See Hughes, Champion and Murdoch *Construction Contracts Law and Management* (2015) 277-278 par 17.2.1.

[6] See par 2.6.4.1 above.

[7] See par 2.6.4.2 above.

[8] Hugo "Construction guarantees and the Supreme Court of Appeal (2010 – 2013)" in Visser and Pretorius *Essays in Honour of Frans Malan* (2014) 159 173.

[9] Hugo (n 8) 173. In South Africa this is especially true of the JBCC construction guarantees which have been interpreted in many cases, including *Dormell Properties 282 CC v Renasa Insurance Co Ltd* 2011 (1) SA 70 (SCA); and *Granbuild (Pty) Ltd v Minister of Transport And Public Works, Western Cape* [2015] ZAWCHC 83 (5 June 2015). See further par 8.3 and 8.4 below.

[10] Affaki and Goode *Guide to ICC Uniform Rules for Demand Guarantees URDG 758* (2011) 438 par 599; and Klee *International Construction Contract Law* (2015) 383 par 16.9.

[11] Bertrams *Bank Guarantees in International Trade* (2013) 37 par 3-3; Furst and Ramsey *Keating on Construction Contracts* (2012) 397 par 11-034; Andrews and Millett *Law of Guarantees* (2011) 622 par 16-003 ("use of performance bonds is becoming increasingly prevalent in commerce. They are particularly common in the construction industry"); and Malek and Quest *Jack: Documentary Credits* (2009) 354 par 12.48. The following South African cases, inter alia, related to performance guarantees: *Sulzer Pumps (South Africa) (Proprietary) Limited v Covec-MC Joint Venture* [2014] ZAGPPHC 695 (2 September 2014); *Coface South Africa Insurance Co Ltd v East London Own Haven t/a Own Haven Housing Association* 2014 (2) SA 382 (SCA); and *Compass Insurance v Hospitality Hotel Developments (Pty) Ltd* 2012 (2) SA 537 (SCA).

particular guarantee is utilised to ensure proper performance of the underlying agreement of the parties. Thus, the performance guarantee safeguards against non-performance, late performance or insufficient performance.[13] Should the party that is entitled to receive performance – for instance the construction or maintenance of a building or plant, the supply of material, or design and supervision of construction works – experience dissatisfaction with the quality or quantity of the performance rendered, it can call up the guarantee. The guarantor then has to comply with the demand, subject to the terms of the performance guarantee, and pay out the monies accordingly. Often, the only stipulated documents for a conforming call under such a guarantee are a demand in writing by the beneficiary, a copy of the cancellation notice of the underlying construction contract or a copy of a court order relating to the liquidation of the contractor.[14] As explained above,[15] any dispute between the employer and the contractor relating to the proper performance or lack thereof is in principle of no concern to the guarantor. The beneficiary accordingly has the assurance of expedient and certain access to the proceeds of the guarantee in the event of it being of the opinion that the applicant has failed to perform its obligations properly.

Usually, a performance guarantee is issued to cover approximately five to fifteen per cent of the contract value,[16] but reportedly even complete coverage amounting to the whole contract value can be agreed upon.[17] The guarantee can also include a contractual clause

[12] Andrews and Millett (n 11) 616 par 16-001; Brook *Estimating and Tendering for Construction Work* (2008) 283; as well as Klee (n 10) 374 par 16.3.3.

[13] Bertrams (n 11) 37 par 3-3; Andrews and Millett (n 11) 621 par 16-003 and 622 par 16-004; Jahrmann *Außenhandel* (2010) 467 par 5.4.4; Ehrlich and Haas *Zahlung und Zahlungssicherung im Außenhandel* (2010) 425 par 9/54; and Spaini *Die Bankgarantie und ihre Erscheinungsformen bei Bauarbeiten* (2000) 232.

[14] *Coface South Africa Insurance Co Ltd v East London Own Haven t/a Own Haven Housing Association* (n 11); *Guardrisk Insurance Company Ltd v Kentz (Pty) Ltd* [2014] 1 All SA 307 (SCA); *Eskom Holdings Soc Ltd v Hitachi Power Africa (Pty) Ltd* [2013] ZASCA 101 (12 September 2013); *Compass Insurance v Hospitality Hotel Developments (Pty) Ltd* (n 11); and *Kwikspace Modular Buildings v Sabodala Mining Company* 2010 (6) SA 477 (SCA).

[15] See par 3.4.2 *et seq* above.

[16] *Cargill International SA v Bangladesh Sugar and Food Industries Corp* [1998] 1 WLR 461 (10 per cent of total contract value); Bertrams (n 11) 37 par 3-3; Hök (n 2) 563 par 18; Kelly-Louw *Selected Legal Aspects of Bank Demand Guarantees* (2009) 36 par 2.4.2.2 ("usually between 5 and 10 per cent of the contract value"); and Malek and Quest (n 11) 354 par 12.48 ("5% or 10%"). Others only mention "a certain percentage of the contract price" in this regard: see Van der Puil and Van Weele (n 2) 271; or an amount of up to 20 per cent of the contract value: see Ehrlich and Haas (n 13) 425 par 9/52.

[17] Jahrmann (n 13) 467 par 5.4.4. Unfortunately, Jahrmann does not offer any examples, references or authorities for his claim. See, however, LG Dortmund 1981 *WM* 280 for such an example of a performance guarantee, albeit not linked to construction but to the supply of forklift trucks, which covered the entire contract value.

stipulating for the adjustment and reduction of the promised sum under the guarantee in accordance with the progress of the construction works, rendering it a so-called "variable" construction guarantee.[18] In the construction environment, cash-flow issues, under-capitalisation and the omnipresent risk of insolvency and liquidation of any of the parties involved in the project make the performance guarantee an almost indispensable instrument.[19]

To illustrate a typical situation in which a performance guarantee was utilised and called up in a high profile construction project, regard may be had to the *Eskom Holdings* case in South Africa. In this case,[20] the South African public utility electricity provider, Eskom, entered into an extensive construction agreement with a Hitachi subsidiary for certain works on power plants in South Africa. Due to the size of the project, Eskom insisted on Hitachi providing several performance guarantees to underpin its numerous obligations in terms of the construction contract. Eventually, a Japanese bank issued demand guarantees in favour of Eskom. Subsequently, the relationship between Eskom, the employer and beneficiary under the performance guarantees, and the contractor, Hitachi, experienced difficulties. Eskom alleged Hitachi to be in material breach of contract, and decided to call up three of the performance guarantees. Hitachi, on the other hand, opposed the demands under the guarantees.[21] However, Eskom's demand was conforming, and as a consequence the court held that it was entitled to be put in funds immediately to remedy any defects or performance deficiencies irrespective of objections by the contractor which could potentially form the subject matter of later litigation (in accordance with the principle "pay first, argue later").[22]

[18] Clause 1.0 in the JBCC Principal Building Agreement (PBA) and the Minor Works Agreement (MWA) Guarantee for Construction. Also, see *Lombard Insurance Company Ltd v Landmark Holding (Pty) Ltd* 2010 (2) SA 86 (SCA) (par 3); Hugo (n 8) 164; and Finsen *The Building Contract* (2005) 100. See also par 6.5 below.

[19] Andrews and Millett (n 11) 622 par 16-004.

[20] *Eskom Holdings Soc Ltd v Hitachi Power Africa (Pty) Ltd* (n 14). The relevant facts and points of law emanating from this decision have been simplified. For a more detailed and profound analysis see Hugo "Protecting the lifeblood of commerce: a critical assessment of recent judgments of the South African supreme court of appeal relating to demand guarantees" 2014 *TSAR* 661 670 *et seq*. See further par 7.2 *et seq* below.

[21] At this stage, the factual and legal arguments advanced by Hitachi and the detailed subsequent rejection by the Supreme Court of Appeal are immaterial to the discussion at hand.

[22] In this regard see par 3.4.2.4 above.

4.3.2 Payment guarantee

Another common type of demand guarantee encountered in the construction environment is the payment guarantee.[23] Such a guarantee secures payment obligations on the part of the employer to the contractor, so that the contractor may rest assured that it will receive payment for its services, material and labour upon completion.[24] In fact, depending on the underlying contract, the contractor may waive (and can be compelled to do so) other forms of security in exchange for a payment guarantee.[25] However, such a payment guarantee can also be used to secure payment between any other parties, for instance the main contractor and subcontractor, employer and design professionals, or contractor and suppliers.[26] Often, a prerequisite for a call under such a payment guarantee are certain documents which point to the completion of the works or supply of material,[27] as well as documents suggesting a failure by the applicant/debtor of having effected payment in a timeous manner.[28] While the payment guarantee can cover the whole contract value,[29] naturally, with reference to party autonomy and freedom of contract, it is for the parties involved to negotiate and settle the appropriate amount.

4.3.3 Maintenance or warranty guarantee

Akin to the performance guarantee, which serves to secure the main obligation of the contractor, the warranty or maintenance guarantee[30] serves to cover the responsibilities of the contractor *after* completion of the work for any defects or imperfections that may become

[23] Klee (n 10) 375 par 16.3.6; and Bertrams (n 11) 41 par 3-7.

[24] Maritz "Doubts raised on the validity of construction and payment guarantees" 2011 *Acta Structilia* 1 7; Hök (n 2) 565 par 22; Schütze and Edelmann *Bankgarantien* (2011) 25 par 2.5; Chambers *Hudson's Building and Engineering Contracts* (2010) 1311 par 10-040; and Ehrlich and Haas (n 13) 427 par 9/58.

[25] For example, in terms of the JBCC Principal Building Agreement the contractor is required to waive its lien on receipt of a payment guarantee (clause 11.10). See also Finsen (n 18) 67 par 6.2.3.

[26] *First Rand Bank v Brera* 2013 (5) SA 556 (SCA); BGH 1985 *NJW* 1829. Further, in *Nedbank v Procprops* [2013] ZASCA 153 (20 November 2013) the obligation of the lessee under a long-term lease agreement was underpinned by such a payment guarantee.

[27] For example a payment certificate issued by the principal agent or engineer.

[28] *First Rand Bank v Brera* (n 26). See also Furst and Ramsey (n 11) 151 par 5-014 *et seq*.

[29] Schütze and Edelmann (n 24) 26 par 2.5.

[30] Klee (n 10) 374-375 par 16.3.4; Malek and Quest (n 11) 356 par 12.52; and Kelly-Louw (n 16) 38 par 2.4.2.5.

apparent during the statutory or contractual warranty period.[31] Should any defects occur in such a period, the employer can turn to the contractor and demand rectification in accordance with the construction contract. If the contractor fails to do so, the employer may then claim the money under the demand guarantee to pay for the rectification of the defect or defects concerned. Such a guarantee can also be advantageous for the contractor in that it opens the way for the employer to pay the full contract price on completion without insisting on retention money or withholding payment of the last or later instalments.[32] With the warranty guarantee issued in its favour the employer can be assured that the contractor will, as Kelly-Louw describes it, "continue to fulfil his obligations during the maintenance or warranty period".[33] A maintenance guarantee can accordingly be regarded as a specific kind of performance guarantee but with a narrower focus on the obligation *after* the substantial completion of the construction works.

4.3.4 Tender or bid guarantee

The tender and bid guarantee offers protection for the party calling for construction tenders,[34] which is often a government agency, public body or a parastatal entity.[35] After a tender has been awarded to one of the bidding parties, the documentation and any agreements ancillary to the construction contract must still be executed and finalised. In order to secure such a process, tender guarantees are regularly required to be submitted alongside the individual tenders.[36] Kelley summarised the objective of these guarantees thus: "Bid guarantees are

[31] Hök (n 2) 564 par 19; Kelly-Louw (n 16) 38 par 2.4.2.5; Ehrlich and Haas (n 13) 426 par 9/56; Spaini (n 13) 270 par 1-2; and Wood *International Loans, Bonds, Guarantees, Legal Opinions* (2007) 389 par 22-004.

[32] Bertrams (n 11) 39 par 3-4; Kelly-Louw (n 16) 38 par 2.4.2.5; and Ehrlich and Haas (n 13) 426 par 9/56. See also the remarks of Graf von Westphalen and Zöchling-Jud *Die Bankgarantie im internationalen Handelsverkehr* (2014) 18 par 34 ("In ihrer Funktion ersetzt sie den Gewährleistungseinbehalt"); and Pike *Engineering Tenders, Sales and Contracts* (1982) 19. On retention money in general, see par 4.5.5 below.

[33] Kelly-Louw (n 16) 38 par 2.4.2.5.

[34] See par 2.5 above for the tendering process in construction.

[35] See Jahrmann (n 13) 464 par 5.4.1; and Kelleher, Mastin and Robey *Smith, Currie and Hancock's Common Sense Construction Law* (2015) 133 *et seq*.

[36] Hök (n 2) 561 par 16. According to Bertrams (n 11) 36 par 3-2, "[t]he conditions or regulations governing the invitation for tenders invariably require bidders to furnish a tender guarantee" (alteration by me). See also the remarks of Spaini (n 13) 216 par 3.

intended to ensure that the bidder will honor its bid, will sign the contract documents if awarded the contract, and will furnish performance and payment bonds."[37]

Therefore, should the successful bidding party not proceed with the conclusion and execution of the contract, due to inability or unwillingness on its part, the tender guarantee can be called upon to compensate the procuring party for losses incurred.[38] Such losses typically include the differences in the bid between the successful party and the next lowest bidder down the line together with the potential costs for repeating the procurement process or renegotiating with other contractors.[39] It must be stressed, however, that in accordance with the independence principle, proof of actual loss is not required if the guarantee is in the nature of a demand guarantee. The presentation of a confirming demand suffices.

Typically, the guaranteed sum under the tender guarantee amounts to anything from one to five per cent of the tender value.[40] The submission of tender guarantees imply seriousness on the part of the competing parties and serves as an indicator of their commitment to the contractual relationship, should they win the bid.[41]

4.3.5 Repayment or cash advance guarantee

To provide for the regular business practice of arranging a cash advance for the contractor,[42] the repayment or cash advance guarantee is also well-established in construction projects.[43]

[37] Kelley *Construction Law* (2013) 206 par 19.1.1. Even though she mainly refers to accessory guarantee contracts, this quote is equally fitting.

[38] Hök (n 2) 561 par 16; Schütze and Edelmann (n 24) 22 par 2.1; Kulick *Auslandsbau* (2010) 225 (although making reference to a mere accessory bid guarantee); Blesch and Lange *Bankgeschäfte mit Auslandsbezug* (2007) 131 par 507; Graf von Westphalen and Zöchling-Jud (n 32) 13 par 24; Delmon "Tendering for the future – you get what you pay for" 2002 *The International Construction Law Review* 446 450 par (d); Robinson, Lavers, Tan and Chan *Construction Law in Singapore and Malaysia* (1996) 207; and Pike (n 32) 19.

[39] Van der Puil and Van Weele (n 2) 271; Gould and Joyce *Construction Project Management* (2003) 181; Delmon (n 38) 450 par (d); Edwards, Lord and Madge *Civil Engineering Insurance and Bonding* (1996) 102; as well as Pike (n 32) 19.

[40] Spaini (n 13) 217 par 4; Bertrams (n 11) 36 par 3-2; Jahrmann (n 13) 464 par 5.4.1 ("2 bis 5 % des Auftragswertes"); and Graf von Westphalen and Zöchling-Jud (n 32) 14 par 25.

[41] Van der Puil and Van Weele (n 2) 271; Andrews and Millett (n 11) 630 par 16-009; Malek and Quest (n 11) 355 par 12.49; Kelly-Louw (n 16) 36 par 2.4.2.1; and Delmon (n 38) 450 par (d).

[42] Bailey *Construction Law Volume I* (2011) 389 par 6.24; and Spaini (n 13) 263 par 1.

[43] See, for instance, *TTI Team Telecom International Ltd v Hutchison 3G UK Ltd* [2003] 1 All ER (Comm) 914, where the parties used the term "advance payment bond" for the instrument in question, as well as *Basil*

According to Bertrams, "[i]n most major contracts, the […] contractor negotiates for advance payments, which ordinarily range from 5% to 30% of the contract value, in order to be able to finance the transaction, especially in the initial phase of execution."[44]

Because of the risk arising from the advancing of funds before the actual construction has started, the employer will be well-advised to require a repayment guarantee. This guarantee underscores the obligation on the part of the contractor to commence and complete the work, or otherwise to repay the cash advance.[45] Therefore, should the employer deem the contractor to have failed to provide the agreed work, it can rely on the guarantee to have the cash advance repaid.

4.3.6 Retention money guarantee

Apart from the often encountered guarantees introduced above, there are more ways to facilitate security through demand guarantees in construction. Given the fact that demand guarantees are consensual the parties are, of course, free to negotiate and use such guarantees as they see fit, and to tailor them to suit their business needs. Therefore, no listing of demand guarantees in a construction environment can be truly exhaustive – parties may always come up with new ways of modifying a demand guarantee to serve a particular cause within their relationship.[46]

One example of such a guarantee is the so-called retention money guarantee,[47] which can be furnished on the behest of a contractor to the employer. If such a guarantee has been

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Read (Pty) Ltd v Nedbank Ltd [2012] ZAGPJHC 101; *Phenix Construction Technologies (Pty) Ltd v Hollard Insurance Company Limited* [2015] ZAGPJHC 282 (10 December 2015); and *Meritz Fire and Marine Insurance Co Ltd v Jan de Nul NV* [2011] EWCA Civ 827 (cash advance guarantee in a shipbuilding context). Note also Davis *Refund Guarantees* (2015), who thoroughly investigates "refund guarantees" (mostly in the shipbuilding industry), which essentially are, in most instances, repayment or cash advance guarantees.

[44] Bertrams (n 11) 39 par 3-5 (insertions and omission by me). Jahrmann (n 13) 465 par 5.4.2 mentions a guaranteed amount equal to the cash advance, which reportedly is 10 to 30 per cent of the contract value.

[45] Hök (n 2) 565 par 21; Malek and Quest (n 11) 355 par 12.50; Wood (n 31) 389 par 22-004; and Graf von Westphalen and Zöchling-Jud (n 32) 14-15 par 26.

[46] Hugo "Letters of credit and demand guarantees: a tale of two sets of rules of the International Chamber of Commerce" 2017 *TSAR* 1 17 par 6 (iii).

[47] Bertrams (n 11) 495 par 19-1; Chappell *Understanding JCT Standard Building Contracts* (2012) 75-76; Malek and Quest (n 11) 355-356 par 12.51; Klee (n 10) 375 par 16.3.5 *et seq*; MacRoberts *MacRoberts on Scottish Construction Contracts* (2015) 226 par 8.6.4 and 495 par 23.2.6; Kelly-Louw (n 16) 37-38 par 2.4.2.4; and Ndekugri and Rycroft *The JCT 05 Standard Building Contract* (2009) 415 par 15.10.3. See

issued, the employer can release the retained money which serves to remedy any defects occurring during the warranty period after completion of the work.[48] This, of course, improves the cash flow of the contractor. The retention guarantee effectively substitutes the retention money.[49] In case latent defects surface within the period covered by contractual or statutory liability the employer can rely on the retention money guarantee "securing repayment of the released retention moneys if defects are later found or if the contractor fails to complete the contract".[50] Coupled with a contractual mechanism to adjust the guaranteed sum (the so-called variable guarantee) as the work progresses,[51] such a guarantee is a very useful device. It is to be noted, however, that the function and purpose of this type of guarantee overlaps with that of the maintenance and performance guarantee.[52]

4.4 Utilisation of demand guarantees: critical assessment

In the construction industry demand guarantees do not only secure the timely payment of monies as in the case of a payment guarantee or a repayment guarantee for a cash advance. They often relate to non-monetary obligations such as the proper performance of a construction or maintenance contract. Furthermore, the actual formation of a construction contract after a successful tender-awarding process can be secured by means of a demand guarantee. Some argue that this very point could be the distinctive aspect separating demand guarantees from standby letters of credit.[53] For instance, McKendrick states that

> "[d]emand guarantees […] are used almost exclusively to underpin non-monetary obligations in international transactions, typically the obligations of the contractor under an international construction contract".[54]

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further Hök (n 2) 564-565 par 20. The issue of abusive demands on retention money guarantees is discussed in par 5.2.8 (in the context of the fraud defence) and par 6.5 (in the context of the terms of the guarantee offering a defence to the guarantor) below.

[48] On retention money in construction, see par 4.5.5 below.

[49] Mugasha *The Law of Letters of Credit and Bank Guarantees* (2003) 68.

[50] Kelly-Louw (n 16) 38 par 2.4.2.4.

[51] Hugo (n 8) 164, with valuable reference to Finsen (n 18) 100; and Bertrams (n 11) 40 par 3-6. See the discussion in par 6.5 below.

[52] Mülbert *Mißbrauch von Bankgarantien und einstweiliger Rechtsschutz* (1985) 20 par D. See also Klee (n 10) 376.

[53] DiMatteo *International Contracting Law and Practice* (2013) 131-132 par [B]; and Horowitz (n 2) 85 par 5.07.

[54] McKendrick *Goode on Commercial Law* (2010) 1129 (alteration, insertion and omission by me).

While this probably holds true when one looks at the business *practice* in construction contracts, there is no reason to believe that demand guarantees are *legally* restricted to cover only non-monetary obligations.[55] Recent South African cases[56] clearly show that the issue whether the guarantor's obligation relates to an underlying contract concerning a monetary or non-monetary commitment is irrelevant in order to determine whether the instrument is a demand guarantee.[57] And indeed, McKendrick is careful to point out that "it is important to appreciate that the differences between a standby credit and a demand guarantee lie in business practice, not in law".[58] The types of demand guarantees widespread in construction are most notably tender guarantees, performance and maintenance/warranty guarantees, repayment, cash advance and retention money guarantees, as well as payment guarantees. The merits and advantages of demand guarantees, and their practical application in the construction industry, have been illustrated.[59]

However, the utilisation of demand guarantees to underpin various obligations in the wider construction environment is not beyond criticism.[60] First of all, the insistence of having demand guarantees integrated into the business transaction necessitates the involvement of banks or other reliable and financially able entities. If a so-called parent-company guarantee[61] cannot be obtained or is deemed undesirable,[62] then, naturally, this comes at a price as the

[55] See for instance Klee (n 10) 373 par 16.2; and Bertrams (n 11) 35.

[56] *Monetary obligation*: *Nedbank v Procprops* (n 26) (guarantee intended to secure timely payment of rent for leased property); *Basil Read (Pty) Ltd v Nedbank Ltd* (n 43) (advance repayment guarantee); *non-monetary obligation* (construction or performance guarantee): *Coface South Africa Insurance Co Ltd v East London Own Haven t/a Own Haven Housing Association* (n 11); and *Compass Insurance v Hospitality Hotel Developments (Pty) Ltd* (n 11).

[57] See Schütze and Edelmann (n 24) 22 par 2.

[58] McKendrick (n 54) 1130.

[59] See chapter 3 above.

[60] Hughes, Champion and Murdoch (n 5) 279 par 17.2.2 deem the use of demand guarantees in construction "on the whole undesirable" – a statement which is, especially given their lack of proper elaboration and explanation, unfortunate and probably inappropriate.

[61] Davis *Construction Insolvency* (2014) 772 par 19-011; MacRoberts (n 47) 486; Hughes, Champion and Murdoch (n 5) 277 par 17.2; and Graf von Westphalen and Zöchling-Jud (n 32) 649-650 par 184-190 ("corporate guarantees").

[62] Undesirable in the sense that such parent company guarantees need not necessarily offer security which is comparable to demand guarantees in regard to the ease and certainty with which they can be realised and called up; note the elaborations below, par 4.5.2 (potential issue of mere accessory nature) and par 4.5.3 (potential lack of documentary nature). See also Wong "Recent developments on demand bonds and guarantees in England and Australia" 2012 *The International Construction Law Review* 51 55 par 2.3; and MacRoberts (n 47) 486 and 490 par 23.1.5.

guarantor will require compensation for its services and risk exposure.[63] The guarantor is entitled to expect "commission for its services and credit risk and for reserving or capitalising liquid assets in the event of payment",[64] which can include the reasonable "incidental expenses" incurred for the handling and processing of the guarantee, like administration, execution and telecommunication.[65] Subject to express contractual provisions, such costs for procuring the guarantee are initially to be borne by the applicant.[66] The applicant, in turn, will therefore include all costs and commissions relating to the procurement of the guarantee into its contract price.[67] Consequently, in a construction setting, it is the employer who effectively pays the guarantee costs.[68] Given that it is the employer, however, who will benefit most from the guarantee due to the protection it offers (at least in the case of the most prevalent construction guarantee), this can be deemed to be a fair allocation.

The costs for issuing a demand guarantee vary considerably in practice, because of the manifold factors relevant to their calculation (risk of default, duration and maximum liability of the guarantor's undertaking, credit-worthiness of the applicant, security available to ensure the claim for reimbursement should the guarantor have to pay under the guarantee, and the type and wording of the demand guarantee requested).[69] Unfortunately, this makes the estimation of the financial implications less predictable, and hinders the comparability of different offers for the issuance of demand guarantees. Moreover, the danger of an abusive call under a demand guarantee must be added to considerations regarding the costs of demand guarantees. As scholars have stated, "a contractor will want to cover the risk of an unfair call

[63] For instance, Ndekugri and Rycroft (n 47) 451 par 16.20 mention a "premium ranging typically from 1 to 3 per cent" of the guarantee amount. Unfortunately, Ndekugri and Rycroft do not specify whether they refer to a periodic premium (for the duration of the guarantee in operation) or just a one-off payment.

[64] Bertrams (n 11) 122 par 10-9.

[65] Bertrams (n 11) 123 par 10-10; Ehrlich and Haas (n 13) 447 par 9/91; Graf von Westphalen and Zöchling-Jud (n 32) 426 par 113; and Häberle *Handbuch für Kaufrecht, Rechtsdurchsetzung und Zahlungssicherung im Außenhandel* (2002) 896.

[66] *Guardrisk Insurance Company Ltd v Kentz (Pty) Ltd* (n 14) (per Theron JA at 2); Bertrams (n 11) 122 par 10-9; Ehrlich and Haas (n 13) 445 par 9/87; and Häberle (n 65) 896. Under German law, this notion stems from paragraphs 675, 670 BGB (German Civil Code) which, while not necessarily directly applicable to abstract demand guarantees, give sufficient legal guidance.

[67] Ndekugri and Rycroft (n 47) 451 par 16.20; and Dunham "The use and abuse of first demand guarantees in international construction projects" 2008 *The International Construction Law Review* 273 273-274.

[68] Except for instances where the demand guarantee secures the payment obligation on the part of the employer towards the contractor.

[69] See Ndekugri and Rycroft (n 47) 451 par 16.20; Brook (n 12) 283; Häberle (n 65) 896; and Häberle *Handbuch der Akkreditive, Inkassi, Exportdokumente und Bankgarantien* (2000) 744-745 par 8.5.3.

in his tender price"[70] and thus increase the overall costs of the construction project. In case of a conforming demand under a demand guarantee, the applicant is liable to the guarantor for reimbursement.[71] Therefore, should the guarantee be invoked in a formally conforming yet abusive or fraudulent manner, the applicant is financially exposed and forced to initiate legal action against the beneficiary should it wish to recover the guaranteed sum.[72] Such a claim, however, leaves the applicant with the usual litigation or arbitration and insolvency risks.

Nevertheless, the aforementioned issues regarding the utilisation of demand guarantees in construction must also be evaluated in light of the following respects: first, demand guarantees provide an excellent degree of protection, and have proven their readiness to meet commercial expectations worldwide. Secondly, the employer will in any event generally have to bear the cost of whatever security the contractor needs to procure – and not only if it is in the form of a demand guarantee. Moreover, the costs of a demand guarantee are comparatively low since the guarantor does not have to "expend time and resources investigating the validity of a claim", as noted by Coleman.[73] Due to the principles of independence and strict documentary compliance the guarantor merely has to inspect the tendered documents as opposed to assessing the underlying material merits of the beneficiary's claim. The guarantor thus avoids "run[ing] a high risk of becoming involved in litigation over an allegedly unjustified claim".[74] Additionally, the applicant can be required to lodge a cash deposit or other form of security in favour of the bank before the guarantee is issued in order to secure the guarantor's reimbursement[75] which will also contribute to a lower cost for the guarantee.[76]

Finally, the possibility of an abusive call under the demand guarantee must be addressed. Andrews and Millett argue that "[t]he nature of performance bonds clearly leaves them open

[70] Dixon, Gösswein and Button "On-demand performance bonds in the international market and adjudication as a means of reducing the risks" 2005 *The International Construction Law Review* 284 285, with specific reference to *Edward Owen Engineering Ltd v Barclays Bank International Ltd* [1978] QB 159.

[71] See par 3.3 above.

[72] See par 3.4.2.4 above.

[73] Coleman "Performance guarantees" 1990 *LMCLQ* 223 230; and Andrews and Millett (n 11) par 16-006.

[74] Coleman (n 73) 230 (insertion by me).

[75] See par 3.3 above.

[76] But, note also Canaris *Bankvertragsrecht Erster Teil* (1988/2005) 754 par 1113, who – quite convincingly it is submitted – draws the attention to the fact that the requirement of a cash deposit by the applicant defeats the purpose of using the demand guarantee to replace the traditional means of a cash deposit in construction.

to abuse by an unscrupulous beneficiary".[77] Similarly, Kelly-Louw states that applicants are "often […] at the mercy of an unscrupulous beneficiary".[78] Such abusive calls arise in situations in which the beneficiary is not materially entitled to any money under the underlying contract, yet is able to meet the formal requirements of the guarantee, and claims. Leaving aside the contentious issue as to the necessary degree and extent of knowledge on the part of the beneficiary relating to the lack of its material entitlement for the demand to be "abusive" or "fraudulent",[79] several points must be taken into account. Most importantly, the calling up of a demand guarantee is a comparatively rare event,[80] therefore, logically, abusive calls are even rarer.[81] This is in line with the observation referred to above that while commercial letters of credit, as payment instruments, are called up regularly, demand guarantees usually fulfil a different role; they are "secondary in intent but primary in form".[82] Their dominant function is to provide security and not payment.

Furthermore, the risk of abusive demands under demand guarantees can be mitigated by so-called "bad call insurance" which can indemnify the contractor against abusive or unfair calls on demand guarantees by the beneficiary.[83]

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[77] (n 11) 650 par 16-020 (alteration by me).

[78] Kelly-Louw "Limiting exceptions to the autonomy principle of demand guarantees and letters of credit" in Visser and Pretorius *Essays in Honour of Frans Malan* (2014) 197 215 (insertion and omission by me).

[79] See par 5.2 *et seq* below.

[80] For instance, Bertrams (n 11) 287 estimates that "demands for actual payment are made in approximately 3%-5%, or even less, of all guarantees and standby letters of credit" (see also 495). See further Lehtinen "Demand guarantees in construction contracts: the Finnish perspective" 2010 *The International Construction Law Review* 511.

[81] Häberle (n 65) 888 par 10.4.6; and (n 69) 736 par 8.4.2 describes abusive and unjustified calls on demand guarantees as "very rare" events (the original German from the two books reads "sehr selten"). Further, see Graf von Westphalen "Neue Tendenzen bei Bankgarantien im Außenhandel?" 1981 *WM* 294 304 ("lediglich in etwa 0,1% der Fälle kommt es zu Meinungsverschiedenheiten und Disputen"). Note, however, the report in "Diskussionsbericht zu den Referaten Coing und Nielsen" *1983 Zeitschrift für das gesamte Handelsrecht und Wirtschaftsrecht* (*ZHR)* 162 (disputes relating to the entitlement to call up the guarantee are often settled by way of negotiation or arbitration; evaluation of court decisions only, therefore, does not give an accurate assessment of the frequency of disputes – "Es wurde aber auch darauf hingewiesen, daß Meinungsverschiedenheiten über die Berechtigung der Inanspruchnahme von Bankgarantien nicht selten im Verhandlungswege beigelegt oder vor Schiedsgerichten ausgetragen würden, so daß die alleinige Berücksichtigung von Entscheidungen der ordentlichen Gerichte kein vollständiges Bild abgebe").

[82] Kelly-Louw (n 16) 51 par 2.5.1.3 (italics omitted).

[83] Murray, Holloway and Timson-Hunt *Schmitthoff The Law and Practice of International Trade* (2012) 255 and 470; Haynes *The Law Relating to International Banking* (2010) 296 par 10.75 and 297 par 10.78; Graf von Westphalen and Zöchling-Jud (n 32) 637 par 135-138 and 642 par 159 as well as 645-646 par 167-170; Bunni *The FIDIC Forms of Contract* (2005) 284 par 15.7; Jahrmann (n 13) 463 par 5.2 (with reference to "Vertragsgarantiedeckungen"); Andrews and Millett (n 11) 597-598 par 15-010 and 651 par 16-020; Mugasha (n 49) 182-183; Marston "Pre-arbitral ADR techniques and conditional letter of credit performance

However, unfair and abusive demands under primary guarantees remain a problem and danger in commerce. In the construction industry this has led some commentators to suggest that they should be avoided and that retention money should be used instead.[84] Due to their continued popularity, however, and the disadvantages of retention money,[85] this is not a viable solution. It is suggested that the best approach to the problem is to develop a sound (international) understanding of the law in this regard. This will enable all parties concerned to appreciate the benefits, implications and risks associated with demand guarantees, and, accordingly, to integrate them into their commercial transactions with a clear awareness of possible pitfalls and dangers, while taking advantage of the security offered by these instruments. Unfortunately, almost every security or contractual instrument can be abused by an unscrupulous party.[86] Unfair and fraudulent practices are a general commercial reality which, by no means is limited or particular to demand guarantees.

4.5 Alternative means of security in the construction industry

4.5.1 Introduction

The versatility of demand guarantees and their comparative advantages emerge when they are compared to other security instruments that are encountered in the construction industry.[87] The most prominent and widespread other forms of security in this regard are considered below.

guarantees" 2002 *The International Construction Law Review* 526 527; and probably also Kelly-Louw (n 16) 120 par 2.12. Further see the early remarks of Edwards "The role of bank guarantees in international trade" 1982 *Australian Law Journal* 281 285 with reference to governmental and state institutions facilitating insurance cover against "arbitrary" and "capricious" calls on demand guarantees.

[84] This is exactly the notion which Hughes, Champion and Murdoch (n 5) 279 par 17.2.2 subscribe to. They favour the use of retention money instead.

[85] See par 4.5.5 below.

[86] See Bertrams (n 11) 79; and Nielsen "Ausgestaltung internationaler Bankgarantien unter dem Gesichtspunkt etwaigen Rechtsmißbrauchs" 1983 *Zeitschrift für das gesamte Handelsrecht und Wirtschaftsrecht* (*ZHR)* 145 146 ("Die Möglichkeit des Rechtsmißbrauchs ist jetzt kein spezielles Phänomen der Bankgarantie").

[87] See also the reference to so-called parent-company guarantees in par 4.4 above.

4.5.2 Accessory guarantee (suretyship and "Bürgschaft")

The various obligations under a construction contract can also be secured through a contract of suretyship, which is sometimes also referred to as "traditional guarantee", "conditional guarantee"[88] or merely as a contract of "guarantee", and in Germany as "Bürgschaft". Such an accessory guarantee establishes an obligation on the surety to answer for any failure of the original, primary debtor. Depending on the construction of the agreement, it may relate to the completion of construction works, delivery of material, payment of the contract price or the repayment of a cash advance. The principle of independence applicable to demand guarantees, is the main feature which sets them apart from these "accessory" contracts of guarantee or surety.

The traditional guarantee is structured as an accessory, secondary contract of security, which only serves to satisfy a creditor in circumstances where the original, primary debtor is unable or unwilling to perform.[89] Given its accessory nature the obligation of the surety to the beneficiary corresponds closely to the original debt of the primary debtor,[90] both as regards the monetary extent of the debt, and as regards possible defences which may be available to the debtor.[91] The dependence of the suretyship on the original debt (for instance, the obligation to deliver certain goods, build a structure or to maintain and improve a production facility) – that is the secondary and accessory nature of the surety's liability, is its main drawback. As Bertrams explains:

> "Apart from the specifically agreed upon terms and conditions, the rights and obligations of parties and more specifically the conditions of payment under a contract of suretyship are fixed by the co-extensiveness principle. By virtue of this principle the underlying relationship is transposed, as it were,

[88] For example, in the case of *Minister of Transport and Public Works, Western Cape v Zanbuild Construction (Pty) Ltd* 2001 (5) SA 528 (SCA) the term "conditional bond" was used. Generally, the use of the expression "conditional guarantee/bond" to contrast them with independent guarantees may be misleading – independent guarantees are also never entirely unconditional but require the submission of certain documents or at least a (written) demand by the beneficiary to trigger payment. See also Hugo "Bank guarantees" in Sharrock *The Law of Banking and Payment in South Africa* (2016) 437 441 n25.

[89] For example, the defence of excussion (*beneficium excussionis*) is of importance here. In German law, the beneficiary of a "Bürgschaftsvertrag" usually has to initiate enforcement measures against the *principal debtor* first before it may claim against the guarantor ("Bürge"), see paragraphs 771 *et seq* BGB.

[90] Scholars use the expression "co-extensiveness" and "co-extensive", respectively, in this regard Davis (n 43) 4-5 par 2.12; Bertrams (n 11) 45; Ellinger, Lomnicka and Hare *Ellinger's Modern Banking Law* (2011) 907; Enonchong *The Independence Principle of Letters of Credit and Demand Guarantees* (2011) 49 par 3.63; Kelly-Louw "General update on the law of demand guarantees and letters of credit" 2016 *Annual Banking Law Update* 43 45; and Kelly-Louw (n 16) 52.

[91] Gullifer *Goode on Legal Problems of Credit and Security* (2013) 367-368 par 8-02; Bertrams (n 11) 45 par 4-1; Lwowski, Fischer and Langenbucher *Das Recht der Kreditsicherung* (2011) 256-257 par 4; Hugo (n 46) 14 par 5; Enonchong (n 90) 30 par 3.03; and McKendrick (n 54) 1129.

> to the relationship between surety and beneficiary/creditor, and the content and extent of the surety's liability, both as a matter of substance and as a matter of evidence, are determined by the principal debtor's liability towards the creditor according to the underlying relationship."[92]

This emphasises a critical weakness of a contract of suretyship, especially in a construction context. Disputes originating from building and construction projects can give rise to difficult questions, necessitate expert witnesses and lead to prolonged litigation or arbitration procedures to determine the merits and extent of possible liability of the parties involved.[93] Bearing in mind the potentially tedious and slow process of assessing and proving liability, Van der Puil and Van Weele state:

> "Most employers insist on unconditional guarantees. In the event they call on the guarantee there is no room for discussion with the bank as to whether a contract is in default or not. Upon calling in the guarantee, the bank's obligation is not only a surety, but the call makes it a primary obligation."[94]

As a result, they take the view that "[i]n practice, conditional guarantees are becoming rare in international contracting".[95] There is no reason to doubt these observations,[96] but it is suggested that in fitting circumstances one could also consider, combining demand guarantees and accessory guarantees. Taking into account the relatively low sums normally secured by demand guarantees, which often amount to only 15 per cent of the contract value, there may be room to secure the remaining value of the contract by means of an accessory guarantee. Hence, an agreement for suretyship or accessory guarantee could be used to counter financial risks *generally*, and a demand guarantee for ensuring swift access to financial relief should certain defaults require more *immediate redress*.

Attention should also be drawn to an instrument peculiar to German law, the so-called "Bürgschaft auf erstes Anfordern".[97] This describes a "Bürgschaft", meaning an accessory

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[92] Bertrams (n 11) 45 par 4-1.

[93] For instance, Bailey reports that complex construction projects can give rise to "some of the most factually detailed and legally complicated disputes one may encounter in commercial law" (Bailey *Construction Law Volume III* (2011) 1419 par 23.02). Maritz (n 24) 6 therefore concludes: "Understandably employers prefer to receive 'on-demand' guarantees because these guarantees can be called up without having to first prove the contractor's default in arbitration or litigation, which can be costly and time consuming".

[94] (n 2) 268; similar also 279 par 14.7. Regarding the term "unconditional guarantee", see the criticism in n 88 above.

[95] Van der Puil and Van Weele (n 2) 268 (alteration and insertion by me).

[96] See also Horn "Bürgschaften und Garantien zur Zahlung auf erstes Anfordern" 1980 *NJW* 2153 n 3, who reported already then that "Der Anteil dieser Verpflichtungsform [guarantees payable on demand] in der internationalen Vertragspraxis wird auf 80% geschätzt" (insertion by me).

[97] OLG Munich 1999 *WM* 2456; Graf von Westphalen and Zöchling-Jud (n 32) 55 *et seq*; Horn *J von Staudingers Kommentar zum Bürgerlichen Gesetzbuch Buch 2 765 – 778 (Bürgschaft)* (2013) 28 *et seq*; Schütze and Edelmann (n 24) 26 par 3.1; Martinek *J von Staudingers Eckpfeiler des Zivilrechts* (2014) 758

type of guarantee or suretyship contract as mentioned immediately above, but with an important modification – it is also payable upon first demand ("auf erstes Anfordern"). When giving such an undertaking, the issuer renounces its right to invoke certain defences typically available to the surety of an accessory contract of security.[98] The waived defences usually relate to the need to exhaust first all remedies and enforcement efforts against the principal debtor (defence of excussion) before turning to the surety, and the right to contest the extent or even the existence of the principal debt. Accordingly, enforcing a "Bürgschaft auf erstes Anfordern" is less cumbersome than that of an ordinary suretyship, and resembles the calling-up procedure under a demand guarantee.[99] Therefore, in many respects the "Bürgschaft auf erstes Anfordern" coincides with the demand guarantee. The most important difference relates to the reimbursement or repayment procedures in cases of abusive and unjustified calls on the instrument.[100] The essential difference is that not (only) the applicant but the guarantor may claim back the money disbursed under the guarantee due to an abusive or unjustified demand.[101] Therefore, this thesis occasionally makes references to German case law and scholarly writing dealing with this modified type of "Bürgschaft", as decisions and commentary are often equally applicable to demand guarantees.

4.5.3 Indemnity

An indemnity agreement is a "binding promise to keep another person financially harmless",[102] and consequently imposes an obligation to "make good a loss suffered by

par 137; and Buch *UN-Konvention über unabhängige Garantien und Stand-by Letters of Credit* (2000 thesis Heidelberg) 188-189.

[98] Schröder *Regress und Rückabwicklung bei der Bankgarantie auf erstes Anfordern* (2003) 25; Horn (n 97) 29; Langenbucher, Bliesener and Spindler *Bankrechts-Kommentar* (2016) 1756-1757 par 7 and 1822-1823 par 15; Martinek (n 97) 758 par 137; Ehrlich and Haas (n 13) 397 par 9/11; and Bamberger and Roth *Kommentar zum Bürgerlichen Gesetzbuch Band 2* (2012) 1068 par 108.

[99] Horn (n 97) 29 (strengthening the beneficiary's legal position regarding the ease with which the Bürgschaft may be called up, similar to a demand guarantee – "Dadurch soll die Rechtsstellung des Gläubigers gestärkt und die Bürgschaft zu einer rasch realisierbaren Sicherheit *ähnlich einer Garantie* gemacht werden" – emphasis is mine); and Martinek (n 97) 758-759 par 137.

[100] Graf von Westphalen and Zöchling-Jud (n 32) 60 par 50; Schütze and Edelmann (n 24) 26-27 par 3.1; Buch (n 97) 189-191; and Martinek (n 97) 759 par 137.

[101] BGH 1994 *WM* 106 107; Graf von Westphalen and Zöchling-Jud (n 32) 60 par 50; Schröder (n 98) 25, 77 and 91-92; and Martinek (n 97) 758-759 par 137. In a demand-guarantee transaction, on the other hand, it is typically the *applicant* who may institute legal action against the beneficiary for recovery of the guaranteed sum.

[102] Bailey *Construction Law Volume II* (2011) 909 par 12.36.

another".[103] Such a contract creates a very flexible and versatile instrument, leading Bailey to conclude: "There are virtually no restrictions on the purpose or content of an indemnity provision when used in a commercial context."[104] For example, indemnity agreements are often used to secure a guarantor's claim for reimbursement against the applicant after having paid out money under the demand guarantee.[105]Andrews and Millett offer the following definition of an indemnity:

> "An indemnity, in the widest sense, comprises an obligation imposed […] by contract on one person to make good a loss suffered by another. Thus most contracts of insurance and all contracts of guarantee fall within the broad definition. However, the expression 'contract of indemnity' is more often used to denote a contract where the person giving the indemnity does so by way of security for the performance of an obligation by another."[106]

Unlike a contract of suretyship or "Bürgschaft", the obligation under an indemnity contract is usually primary in nature.[107] This is an important characteristic which it shares with demand guarantees. However, it differs from demand guarantees in that the event which triggers the indemnity is not necessarily documentary in nature, but may require further evidence or ascertainment.[108] Accordingly, a contract of indemnity does not bring about the certainty of payment (or reimbursement and indemnification, to be more precise) as a demand guarantee would. But this, it must be noted, depends largely on the wording and particulars of the indemnity contract – which means a contract of indemnity could, given appropriate phrasing and construction, function very similarly to a demand guarantee.[109]

[103] Furst and Ramsey (n 11) 93 par 3-068.

[104] (n 102) 911 par 12.39.

[105] See, for example, *Lombard Insurance Company Ltd v Landmark Holding (Pty) Ltd* (n 18) par 8; *Group Five Construction (Pty) Limited v Member of the Executive Council for Public Transport Roads and Works Gauteng* [2015] ZAGPJHC 55 (13 February 2015); *Phenix Construction Technologies (Pty) Ltd v Hollard Insurance Company Limited* (n 43) (par 7); and *Engala Africa (Pty) Ltd v Lombard Insurance Company Ltd* High Court Gauteng (23 June 2016) (unreported judgment).

[106] (n 11) 12 par 1-012 (insertion and omission by me).

[107] Davis (n 43) 6 par 2.22; Affaki and Goode (n 10) 9 par 18; Andrews and Millett (n 11) 12 par 1-013; Bailey (n 102) 910 par 12.37; and Graf von Westphalen and Zöchling-Jud (n 32) 607 par 22 and 608 par 24.

[108] Richter *Standby Letter of Credit* (1990) 86 par V; and Affaki and Goode (n 10) 9 par 18.

[109] However, if a contract of indemnity would be formulated and construed as such, then in actual fact the expression "indemnity" would merely constitute a label, making the classification as a demand guarantee more appropriate. The example of an indemnity clause in Graf von Westphalen and Zöchling-Jud (n 32) 607-608 par 23 would probably, substantially speaking, almost assume the function of a demand guarantee: "*The Guarantor, as a principal and as a separate and independent obligation and liability from its obligations and liabilities under clause [ ] ([the guarantee clause]), irrevocably and unconditionally agrees to indemnify the Beneficiary in full on demand against all losses, costs and expenses suffered or incurred by the Beneficiary arising from or in connection with any of: (a) the Beneficiary entering into [the contract]; (b) any of the provisions of [the contract] being or becoming void, voidable, invalid or unenforceable; or (c) the*

Furthermore, the purpose of an indemnity agreement is – as the terminology suggests – the indemnification of the beneficiary. Logically, therefore, the prerequisite for an indemnity to "bite"[110] is the beneficiary having been "damnified by payment […] [or in cases where he] has incurred a liability, regardless of whether he has made payment".[111] This very fact constitutes yet another aspect by which demand guarantees and indemnity contracts can be distinguished: the sum promised under a demand guarantee does not necessarily have to correspond in its extent to a loss suffered or ascertainably expected by the beneficiary.[112] Even in cases where the beneficiary of a demand guarantee has not sustained financial damages, or where the loss does not fully match the amount stipulated in the demand guarantee, it may still be able to claim under the guarantee.[113] This stands in stark contrast to indemnity contracts, where the maximum amount payable by the party granting the indemnity is, in any event, the actual loss suffered or liability incurred by the beneficiary. Bearing that in mind, a contract of indemnity may provide acceptable protection within a construction relationship but, due to the missing documentary element triggering the realisation of the security, the demand guarantee offers more certainty and predictability to the beneficiary.

4.5.4 Mortgage

A mortgage bond is another contractual means of giving security for a debt owed to a party within a construction context. Depending on the value of the real estate, a mortgage bond can provide excellent assurance. Therefore, some jurisdictions recognise the contractor's statutory right to a mortgage bond upon commencement of construction works.[114] However, in a

failure of the Principal to perform fully and promptly any of its obligations to the Beneficiary under [the contract]".

[110] See Bailey (n 102) 913 par 12.42.

[111] Bailey (n 102) 913 par 12.42 (insertion and omission by me).

[112] See for instance Gullifer (n 91) 367 par 8-01 (n 1 in particular); as well as Brindle and Cox (n 3) 780 par 8-029.

[113] Kelly-Louw (n 78) 214 par V. Regarding the discussion at hand this statement, it is submitted, should be seen as a permissible simplification. The issue whether the beneficiary must have sustained a loss in order to claim under a demand guarantee needs further consideration, which is dealt with in par 5.7 below.

[114] Hök (n 2) 546-552; Jacoby and Peters *J von Staudingers Kommentar zum Bürgerlichen Gesetzbuch Buch 2 631-651 (Werksvertragsrecht)* (2014) paragraph 648 par 1 *et seq*; Büchler and Jakob *ZGB Schweizerisches Zivilgesetzbuch Kurzkommentar* (2012) paragraph 837 par 6 *et seq*; and Honsell, Vogt and Geiser *Basler Kommentar Zivilgesetzbuch II* (2015) paragraph 839/840 par 1 *et seq*. Weselik and Hamerl *Handbuch des*

construction context several issues arise when opting for security through a mortgage bond. Obviously, the mortgage bond can only be granted by the owner of the land or with its consent,[115] which effectively means that in the typical situation only the employer's obligation can be so secured. Any obligations owed by the contractor to the employer cannot be covered by a mortgage bond. This stands in contrast to demand guarantees which can secure any obligation, including the duty on the contractor to repay a cash advance upon default, or to rectify construction failures during the warranty period.

Furthermore, in order to finance the construction and building works the employer may have pledged the land already for obtaining credit by a bank or other financiers, which makes yet a further (second) mortgage bond – if permissible in the jurisdiction – less attractive or even worthless due to prioritised rights.[116] Apart from that, the procurement of a mortgage bond may be both time-consuming and costly as it necessitates the involvement of the Registrar of Deeds, a notary public or other legal facilitator. Lastly, the realisation of the security in an event of default does not promise immediate access to funds, which in the construction industry is an important concern.[117] As in the case of a contract of suretyship it is accordingly suggested that a mortgage bond can be used in fitting circumstances to supplement the security of a demand guarantee – but it cannot be a sufficient alternative to the demand guarantee itself.

4.5.5 Cash deposit, escrow account and retention money

Cash deposits, escrow account payments and retention monies are common features, internationally, in construction. Cash deposits, for instance, are often sought by the employer as security when calling for tenders or to underpin the obligations of the contractor after the awarding of a construction contract.[118] Unquestionably, the cash deposit offers excellent

internationalen Bauvertrags (2015) 49 point out, however, that such statutory security rights are not internationally recognised and only available in certain jurisdictions.

[115] Sonnekus and Schlemmer "Covering bonds, the accessorial principle and remedies founded in equity – not self-evident bedfellows" 2015 *SALJ* 340; and Henssler *Münchener Kommentar Bürgerliches Gesetzbuch Band 4* (2012) paragraph 648 par 2.

[116] Jacoby and Peters (n 114) paragraph 648 par 5; Willmann *Die Bankgarantie im Bauwesen* (2013) 118; and Henssler (n 115) paragraph 648 par 2.

[117] Willmann (n 116) 120-122.

[118] Willmann (n 116) 102 par 3.3.1.

security to the beneficiary, as it is immediately accessible and needs neither valuation nor to be converted for realisation.[119] However, as the cash deposit leaves the debtor exposed and out of pocket at all times,[120] it will naturally include this financial inconvenience and exposure into its contract price and thus drive up the contract price. Moreover, a cash deposit necessarily affects the cash flow of the party furnishing it, and may also impact negatively on investment opportunities that may be available to it.[121]

The provision of security by means of retention money, which is often found in standard-form construction contracts,[122] is similar to a cash deposit. Even though it does not operate through the depositing of funds, cash still plays a central role. As Bailey elaborates, retention money "involves an [employer] retaining a proportion of an amount due to a contractor from a progressive payment, as security for the performance by the contractor of its contractual obligation (including, but not usually limited to, obligations concerning the quality of work performed by the contractor)".[123] Retention money as a means of securing, for instance, the period of warranty after substantial completion of a construction project,[124] leaves the contractor at the mercy of the employer and shifts the burden of enforcement, should it consider further retention unjustified, onto the contractor.[125] Moreover, at the early stages of the project, the employer may be significantly exposed since the amount of the retained funds is small and may accordingly provide insufficient security.[126]

[119] Gullifer (n 91) 230 par 6-04; and Willmann (n 116) 102 par 3.3.1.

[120] Nielsen and Nielsen "The German bank guarantee: lesson to be drawn for China" 2013 *George Mason Journal of International Commercial Law* 171 173. In this regard, see also Nielsen (n 86) 145 ("Abfluß sofortiger Liquidität").

[121] Willmann (n 116) 103 par 3.3.1.

[122] MacRoberts (n 47) 224 par 8.6.1.

[123] (n 102) 895 par 11.03 (alteration and insertion by me, footnotes omitted).

[124] Ramsden *McKenzie's Law of Building and Engineering Contracts and Arbitration* (2014) 216-217 par 18.2; Vygen and Joussen *Bauvertragsrecht nach VOB und BGB* (2013) 1108 par 3067 *et seq*; Furst and Ramsey (n 11) 151 par 5-013; Adriaanse *Construction Contract Law* (2010) 170; and Malek and Quest (n 11) 355-356 par 12.51.

[125] See Willmann (n 116) 102 par 3.3.1. See further Kelly-Louw (n 16) 37-38 par 2.4.2.4 for the so-called retention money guarantee which can be utilised to have the employer release the retention fund before the lapse of the warranty period. See par 4.3.6 above. The abuse of retention money guarantees is discussed below in par 5.2.8 (in the context of fraud), and in par 6.5 (terms of the guarantee offering a defence to a demand for payment).

[126] See Hugo (n 8) 164 (with reference to Finsen (n 18) 98-99).

When opting for retention money, typically up to 5 per cent of the contract value may be retained, whenever instalments or stage payments become due.[127] To prevent the contractor from having to wait for the warranty period to lapse and the retention money finally to be paid out, it can negotiate for a retention money guarantee to be issued to enable earlier release of the funds.[128]

Akin to the retention money scheme is the use of an escrow account in English law, where cash is transferred or deposited to a bank or another reliable third party (notary public, attorney, or escrow agent) and released to the beneficiary only when certain conditions have been met.[129]

4.5.6 Insurance

In construction, risks of practical, financial and legal nature are manifold. They can range from a default in making payment by the employer, damage to the site and work, claims due to damages or injury sustained by a third party, or failure to complete the construction works by contractors and subcontractors due to insolvency or quality problems of any kind. These dangers of financial and substantial losses are risks, in the sense of uncertain events potentially detrimental to property and legitimate business interests, and, as such, generally insurable.[130]

A solution to addressing such construction-related events could therefore be a comprehensive insurance policy, issued and underwritten by a reputable insurance company, at the beginning of the construction project. Andrews and Millett, however, point towards the insurance premium applicable to such undertakings:

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[127] Beale *Chitty on Contracts Volume II Specific Contracts* (2012) 780 par 37-137 ("typically between 3 to 5 per cent"); Chappell (n 47) 74; Bailey (n 102) 895 par 11.03 (with reference to further sources and authorities in his n 9); Adriaanse (n 124) 170; Kelley (n 37) 149 par 13.2 ("typically either 5 to 10 percent"). For the position under German law, see Vygen and Joussen (n 124) 497 par 1301 and 1109 par 3070.

[128] On retention money guarantee see also par 4.3.6 above.

[129] Bailey (n 102) 914 par 12.47; Davies and Nathanson "Standard term escrow agreements: the potential pitfalls for depositors and agents alike" 2013 *Butterworths Journal of International Banking and Financial Law* 587. In Germany the closest equivalent would probably be a *Treuhandkonto* or a *Treuhandsparbuch*.

[130] Wandt *Versicherungsrecht* (2016) 281 par 693; Birds *Insurance Law in the United Kingdom* (2010) 55 par 58 *et seq*; and Clarke *The Law of Insurance Contracts* (2002) 12 par 1-1D1. See further the concise introduction to construction insurance presented in Kelley (n 37) 197-203.

> "Although it may be possible to insure against the contingencies which would trigger payment under the performance bond [default by the employer to pay, failure to complete works by contractor], insurance is often a more expensive option."[131]

Therefore, in their view, primarily the costs involved in procuring insurance advocate for demand guarantees instead. Despite not citing case law or other authority, they argue persuasively with reference to the fact that the issuer of a demand guarantee is spared any involvement "in an investigation of the factual basis for any demand made against it, or in any litigation between the [applicant] and the beneficiary if the demand was allegedly unjustified".[132] The insurer, on the other hand, would certainly have to ascertain the existence and cause of default carefully, as well as the extent of loss and damage, and the liability of the construction parties involved before deciding whether to accept or reject a claim under the insurance policy. The enquiry and investigation by the insurer will naturally entail expenses which would be reflected in the insurance premium.

Moreover, insurance as a contractual means of allocating risks and commercial uncertainty in a transaction operates under a premise which differs fundamentally from demand guarantees – insurance leaves the insurer to bear the "ultimate risk" of losses, while the guarantor has a claim for reimbursement against the applicant upon accommodating a valid claim.[133] This fact is a decisive, conceptional difference. Insurance will place the risk and financial burden, finally, on the insurer. Demand guarantees, on the other hand, incorporate the reimbursement by the applicant. Furthermore, insurance policies may cover certain anticipated risks in their entirety, whereas demand guarantees typically cover only a percentage of the contract value (for example in cases of performance guarantees).

Additionally, two further aspects merit contemplation – time and "comparability". The element of time cannot be disregarded when comparing the advantages of an insurance policy to those of a demand guarantee. While any insurer will have to be granted a reasonable period of time to assess and handle a claim,[134] the guarantor as the issuer of a demand guarantee is expected to act more expeditiously. This stems from the demand guarantee's function to provide swift and certain access to monies, which is the key to its success in the commercial world. The URDG 758, for example, stipulate for the examination of a demand

[131] (n 11) 629 par 16-006 (insertion by me).

[132] 629 par 16-006 (insertion and omission by me).

[133] Merkin and Steele *Insurance and the Law of Obligations* (2013) 38-39 par 3.2.

[134] See Enonchong (n 90) 35 par 3.19, and also the remarks of Andrews and Millett (n 11) 629 par 16-007.

to be completed "within five business days following the day of presentation".[135] Enonchong's conclusion is convincing:

> "In this respect a demand guarantee is better than insurance of the risk of default, since payment under an insurance policy is unlikely to be prompt because the insurance company will normally want to investigate the circumstances before settling a claim under the policy."[136]

In addition to the decisive issue of the time spent on handling and processing an insurance claim, the aspect of "comparability" must be considered. Demand guarantees are typically relatively short and simple instruments and as such relatively easy to compare (for example in the evaluation of submitted tenders). Insurance policies, on the other hand, are more lengthy and complex, and hence more difficult to compare.[137]

4.5.7 Liquidated damages

In order to secure an advantage should the construction work encounter difficulties, the parties to a construction project can include clauses into their contract stipulating for so-called liquidated damages (sometimes also referred to as "stipulated" or "ascertained" damages).[138] Such a liquidated-damage clause "attempts to pre-estimate the loss for breach of contract"[139] and serves to absolve the injured party from having to prove the extent of the damages sustained before claiming.[140] Especially in a construction setting this is common[141] and can be very advantageous, because of the difficulties in establishing and determining the

[135] Art20 (a).

[136] (n 90) 35 par 3.18. See further Mugasha "Enjoining the beneficiary's claim on a letter of credit or bank guarantee" 2004 *The Journal of Business Law* 515 535 and his analysis of accessory and primary guarantees in this regard.

[137] Regard may be had to Delmon (n 38) 456-457 par (a) and 460 par (b). Even though Delmon does not discuss the particular questions relating to insurance policies and demand guarantees in the tender process, he nevertheless emphasises the advantages and benefits of conducting a tender process which places importance on *comparability*.

[138] Uff *Construction Law* (2013) 218; and Bailey (n 102) 1019 par 13.121.

[139] Ellinger and Neo *The Law and Practice of Documentary Letters of Credit* (2010) 334.

[140] See Oberhauser and her remarks regarding "Pauschalisierter Schadensersatz" in Oberhauser *Vertragsstrafe – ihre Durchsetzung und Abwehr* (2003) 4-5 par 8-10; Weselik and Hamerl (n 114) 155; and Bailey (n 102) 1019-1020 par 13.122.

[141] Hughes, Champion and Murdoch (n 5) 336 par 20.2.1 ("Most construction contracts do this"); Chambers (n 24) 886 par 6-022 ("Most standard form contracts make provision for the payment of liquidated damages for delay").

exact amount of damages suffered.[142] Should a breach of contract occur, the innocent party can resort to claiming the predetermined amount from the party at fault.[143]

While certainly useful and advisable, liquidating damages cannot compete with demand guarantees.[144] Mainly, this is due to three aspects: first of all, enforcement is not as swift and expeditious but could require extensive litigation or arbitration. Furthermore, the stipulated amount may be subject to judicial review and adjustment or even be declined in its entirety. Payment is therefore less certain than in the case of a demand guarantee.[145] Finally, clauses for liquidated damages form part of the construction contract and are therefore only relevant in an action between the parties to the contract (the employer and contractor, or the contractor and subcontractor). In instances of the defendant party's insolvency, therefore, they provide very little security indeed.

4.6 General concluding remarks and analysis

Guarantees, payable on demand, are a common feature in the international construction industry[146] – and rightfully so. Their independence and liquidity render them superior to accessory guarantees, while their documentary nature holds legal certainty which sets them apart from the usual indemnity agreements. Demand guarantees are easier to execute and more versatile than mortgage bonds or contractual promises for liquidated damages, and offer

[142] See Furst and Ramsey (n 11) 359 par 10-001; Bailey (n 102) 1019-1020 par 13.122; and Finsen (n 18) 15.

[143] Therefore, Uff (n 138) 218 speaks of a "convenient device" in regard to a liquidated damages clause.

[144] See also the remarks by Willmann (n 116) 41 who reports, although without specific reference to liquidated damages, the increasing importance of demand guarantees as security due to their incomparable legal properties ("Es verstärkt sich dahingehend der Eindruck, dass der Bankgarantie als Sicherstellungsmittel eine zentrale Rolle zukommt, die sie aufgrund ihrer Beschaffenheit nahezu konkurrenzlos erscheinen lässt").

[145] See, generally, Hök (n 2) 1113-1114 par 48-49 (on common and civil law). For the position under English common law see Hachem *Agreed Sums Payable upon Breach of an Obligation* (2011) 34 par D and 57 *et seq*; Adriaanse (n 124) 172-191; Furst and Ramsey (n 11) 363-376 par 10-004-10-020; Hök (n 2) 1175-1176 par 61-62 as well as 1178-1179 par 66; McKendrick (n 54) 137 par 6; Chambers (n 24) 886-890 par 6-022 and 6-023 as well as 924-935 par 6-044-6-047; and Goode *Payment Obligations in Commercial and Financial Transactions* (1983) 45-46 par (2). On South African law see the Conventional Penalties Act 15 of 1962 as well as the National Credit Act 34 of 2005 s172 (1) and attached schedule 1; Loots *Construction Law and Related Issues* (1995) 77-78 par 2.12.10; Christie and Bradfield *Christie's The Law of Contract in South Africa* (2011) 584-588; Van Huyssteen and Maxwell *Contract Law in South Africa* (2015) 148-149 par 286-289; and Finsen (n 18) 15. On German law see Oberhauser (n 140) 5 par 11-12; Krüger *Münchener Kommentar zum Bürgerliches Gesetzbuch Band 2* (2016) paragraph Vorbemerkung 339 par 11 and 14; and Bassenge *Palandt Bürgerliches Gesetzbuch* (2016) paragraph 276 par 26 and paragraph 309 par 24-39.

[146] Klee (n 10) 372 par 16.1 ("The bank guarantee has become so popular during recent decades that it now appears in most standard forms of contracts in large construction projects").

more safeguards against unfair calls than cash deposits, escrow accounts and retention money, and have significant cash-flow advantages. In comparison to insurance policies, they offer more expeditious access to funds and carry the benefit of "comparability" and comparatively low costs. It is submitted that the swift access to funds provided by demand guarantees, that is often necessary to rectify construction defects and ensure cash flow in a construction project, is best realised by these instruments. The demand guarantee, therefore, is an indispensable and vital element of risk management and provides unprecedented financial liquidity coupled with legal certainty in international construction. They are and should accordingly remain "a standard feature of many international projects".[147]

[147] Wilmont-Smith *Construction Contracts Law and Practice* (2010) 194 par 9.21.

Chapter Five: The abuse of, and other problems relating to, demand guarantees in the construction industry

5.1 Introduction

The use of demand guarantees is a well-established feature in construction and international trade as is, unfortunately, their *abuse*.[1] The main focus in the centre piece of this thesis – Chapters Five to Seven – is on the extent to which the guarantees encountered in the construction industry may be vulnerable to abusive calling, and in which situations such an abuse typically arises. This leads to the question as to how these risks and impermissible demands are addressed in guarantees used in construction and the legal systems under consideration, and how risks and problems can be remedied and prevented by the parties.[2] Reference is made, whenever appropriate, to particular provisions found in standard-form contracts and standard-form guarantees, as well as applicable sets of laws or rules.

It is important to note that instances of questionable or abusive calls on a demand guarantee fall, generally, into two categories. In the first place, abuse and improper calls can relate to the conduct of the beneficiary *with reference to the underlying contract*. In such instances, the independence principle could conceivably be infringed upon. These cases are investigated in this chapter.[3] *Fraud* as interpreted in this context in English and South African law, and the German doctrine of *Rechtsmissbrauch*, constitute the backbone of the discussion.

Subsequently,[4] Chapter Six deals with calls on the guarantee which are potentially abusive and impermissible *in respect of the terms of the guarantee*. If the terms of the guarantee may potentially afford the guarantor a defence against a demand for payment, the independence principle may well be not affected.

Chapter Seven investigates the issue of negative stipulations. The breach of negative stipulations has produced contradictory legal responses which makes it difficult to classify exclusively under either of the aforementioned two chapters (Five and Six). Because the approaches developed in case law in South Africa, England and Germany deviate regarding their stance on whether to allow violations of the principle of independence or not, the issue of negative stipulations is dealt with in a separate, seventh chapter.

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[1] Horn and Wymeersch *Bank-Guarantees, Standby Letters of Credit and Performance Bonds in International Trade* (1990) v Foreword and 1; and Broccoli and Adams "On-demand bonds: a review of Italian and English decisions on fraudulent or abusive calling" 2015 *International Construction Law Review* 103 103-104.

[2] See also chapter 8 below.

[3] See par 5.2-5.9 below.

[4] See par 6.2 *et seq* below.

This approach (grouping instances of abusive calls on a guarantee into two main categories, and negative stipulations into an additional, separate one) facilitates systematisation of the different aspects of abusive calls and thereby, hopefully, contributes to a better understanding of the law relating to guarantees. This division of cases of abuse into these different categories is strongly influenced by the approach typically taken in German law.[5] It will emerge throughout this part of this thesis (Chapters Five to Seven) that this approach may aid a more sound understanding of the law of demand guarantees in general.

Fraud by the beneficiary is an internationally recognised exception to the independence principle in demand guarantees, and offers a valid defence to guarantors and applicants against abusive calls. Problems of fraudulent or otherwise questionable conduct by beneficiaries are presented mostly by way of analysing recent cases emanating from the South African Supreme Court of Appeal (SCA). Moreover, in certain jurisdictions further bases have arisen in case law which could interfere with the principle of independence. Such events include, among others, the final determination of the commercial dispute in the underlying contract, illegality of the underlying transaction, or the unconscionability of the calling up of the guarantee.

In order to examine the notion of possible further exceptions to the independence of demand guarantees, regard must be had to the concept of fraud. Fraud, it is submitted, must be appreciated as the central concept with which the various abusive behaviours of beneficiaries are to be dealt with. Not only must be explored *where* the fraudulent activity has to take place so that an exception can be justified (fraud in the documents/fraud in the narrow sense; fraud in the transaction/fraud in the wide sense), but also *what* conduct qualifies as fraud (no honest belief/knowledge of lack of entitlement, *Rechtsmissbrauch*). While fraud as a defence is accepted internationally it remains conceptually "elusive"[6] and "vague"[7] and, it is respectfully submitted, it is far from being "tightly circumscribed".[8] These issues are first

[5] Canaris *Bankvertragsrecht Erster Teil* (1988/2005) 773 par 1135 *et seq*; Wessely *Die Unabhängigkeit der Akkreditivverpflichtung von Deckungsbeziehung und Kaufvertrag* (1974) 58-71 par 137-180; and Heidbüchel *Das UNCITRAL-Übereinkommen über unabhängige Garantien und Standby Letters of Credit* (1999) 251 *et seq*. See also Hugo *The Law Relating to Documentary Credits from a South African Perspective with Special Reference to the Legal Position of the Issuing and Confirming Banks* (1996 thesis Stellenbosch) 252 *et seq*.

[6] Kelly-Louw *Selective Legal Aspects of Bank Demand Guarantees* (2009) 217.

[7] Kelly-Louw (n 6) 260 par 5.4.2; similar also Bertrams *Bank Guarantees in International Trade* (2013) 366 ("substantive notion of fraud, therefore, remains rather vague").

[8] Quote from a case note by Curle, Choo, Carter and Payton "Fraud and illegality exceptions to banks' obligations to pay under letters of credit" 2014 *Butterworths Journal of International Banking and Financial*

approached from a South African and English perspective, but extensive reference is also made to legal concepts prevalent in German law. The German doctrine of the abuse of rights (*Rechtsmissbrauch*) complements developments and discussion and, at times, may offer guidance on points which have not yet been settled under English or South African law.

5.2 The fraud exception

The notion that fraud by the beneficiary defeats the autonomy of the abstract obligation under the guarantee has enjoyed abundant attention by courts and legal commentators alike, and has been touched upon in Chapter Three.[9] The following discussion of fraud, consequently, draws from what was said above, but pays particular attention to the *different notions* of fraud. It is intended also to pave the way for an in-depth discussion of further forms of abusive calls on demand guarantees. Moreover, it forms the basis from which all considerations relating to further possible exceptions to the independence principle depart. When appropriate, regard is had to certain aspects from discussions above. Also, the German concept of *Rechtmissbrauch* (abuse of rights) is analysed and put into the specific context of demand guarantees and their abuse.

Generally, the question of what amounts to fraud in relation to demand guarantees, it is suggested, is best answered with regard to recent judiciary decisions and developments. There is currently much evidence indicative of a more liberal approach; an approach which departs from the notion of fraud being the simple fraudulent presentation by the beneficiary of *forged documents*, and which increasingly shifts the attention to the *demand-guarantee transaction as a whole:* the positive knowledge of the beneficiary to its material disentitlement to the guaranteed sum.

The fraud exception was first developed within the context of letters of credit to counter attempts by beneficiaries to obtain payment under such letters while *intentionally* failing in *material respect* to comply with the *underlying contract*. To mention one of the most

Law 725. Therefore, see the criticism in Xiang and Buckley "A comparative analysis of the standard of fraud required under the fraud rule in letter of credit law" 2003 *Duke Journal of Comparative and International Law* 293 333 par VI, who make it plain that the standard and the conceptional understanding of fraud differs considerably. The fraud exception in the context of demand guarantees is dealt with in detail in par 5.2 *et seq* below.

[9] See par 3.4.2.5 above.

prominent and early examples, in *Sztejn v J Henry Schroder Banking Corporation*[10] the beneficiary under a letter of credit dispatched "worthless rubbish"[11] instead of the promised goods, and was eventually denied payment under the instrument. This case has contributed greatly to the recognition of the fraud exception, and is regarded by many authors to be the landmark case on the fraud exception.[12] Over time, the fraud defence has been further tested, shaped and refined, so that today one must distinguish mainly between *two notions of fraud*: (i) fraud in the "narrow sense"; and (ii) fraud in the "wide sense". The following discussion relates to these questions, first approached from the perspective of English and South African law and, thereafter, from the perspective of the German doctrine of *Rechtsmissbrauch*.[13]

5.2.1 Fraud in the "narrow sense" in English law

Under the concept known as "fraud in the narrow sense",[14] which has arisen mainly in the context of letters of credit as opposed to demand guarantees, the objectionable conduct by the beneficiary relates to the *documents* in particular.[15] In such cases, the beneficiary forges or otherwise manipulates the documentary evidence which is required under the letter of credit to trigger payment. Documents involved in a letter-of-credit transaction are typically bills of lading, certificates of quality, commercial invoices, packing lists or insurance policies.[16] Under the notion of *fraud in the narrow sense* the fraudulent actions therefore relate directly to these *documents*. In the English case of *United City Merchants (Investments) Ltd v Royal Bank of Canada (The American Accord)*,[17] Lord Diplock in his oft-cited judgment put it thus:

[10] 31 NYS 2d 631 (1941) (Supreme Court New York County Special Term).

[11] 633 (per Shientag J).

[12] See par 3.4.2.5 above.

[13] See par 5.2.9 below.

[14] Expression used, for example, by Kelly-Louw (n 6) 213 *et seq*; and Eitelberg "Autonomy of documentary credit undertakings in South African law?" 2002 *SALJ* 120 126.

[15] See Enonchong *The Independence Principle of Letters of Credit and Demand Guarantees* (2011) 100-101 par 5.14-5.15; Mugasha *The Law of Letters of Credit and Bank Guarantees* (2003) 144 *et seq*; and Malek and Quest *Jack: Documentary Credits* (2009) 254 par 9.15 *et seq*.

[16] See par 3.4.3.2 above.

[17] [1983] 1 AC 168.

> "[T]here is one established exception: that is, 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 knowledge are untrue."[18]

While this narrow approach places heavy emphasis on the independence principle, it does not (need to) take into account the wider context within which letters of credit, and even more so, demand guarantees, operate. Therefore, Xiang and Buckley note: "[I]f fraud is defined too narrowly […] the effectiveness of the fraud rule will be compromised."[19] In the past, English courts used to favour this rather constricted approach to the fraud exception.[20]

5.2.2 Fraud in the "wide sense" in English law

Another interpretation of the fraud defence led to the adoption of the so-called "fraud in the wide sense" exception.[21] This approach proceeds from the notion that not only documentary fraud may be relevant, but the *beneficiary's conduct in relation to the underlying contract* as well; it assesses the behaviour of the parties without necessarily restricting itself to examining the presented documents alone. Therefore, the courts would, if subscribing to such a concept, allow judicial intervention even when the fraud is situated in the *underlying transaction*. Forgery and falsification of documents, according to this interpretation, is not necessarily required to invoke the fraud defence. To illustrate this exception of fraud in the wide sense, Van Niekerk and Schulze give the example of a seller who tenders documents which are in order (that is do not contain misrepresentations but describe the goods accurately in a concise manner), but who nevertheless has knowingly shipped merchandise of inferior quality.[22]

There is authority in English law for the acknowledgment of the fraud exception in the wide sense: in *Deutsche Ruckversicherung AG v Walbrook Insurance Co Ltd; Group Josi*

[18] at 183F-G (alteration by me).

[19] (n 8) 334 (insertion and omission by me).

[20] See Horn and Wymeersch (n 1) 32. For an analysis of the current position in English law see immediately below.

[21] See Van Niekerk and Schulze *The South African Law of International Trade: Selected Topics* (2016) 295 par 3.9.3.4; and Kelly-Louw (n 6) 219 *et seq*. Other authors have termed it "fraud in the transaction". See for instance Enonchong (n 15) 101 par 5.16; and Horowitz *Letters of Credit and Demand Guarantees* (2010) 24 par 2.14 *et seq*.

[22] (n 21) 291 par 3.9.3.1. See also Oelofse "Developments in the law of documentary letters of credit" 1996 *Annual Banking Law Update* 12 (n 68).

Re v Walbrook Insurance Co Ltd,[23] a dispute regarding allegations of fraud under a letter of credit agreement was before the English courts. It was alleged that the claim on the underlying contract was invalid, and therefore the demand on the letter of credit was so, too. However, all allusions to fraudulent conduct were made without reference to the documents required to trigger payment under the documentary credit; rather, reliance was placed on the conduct of the parties and their knowledge (that they were not entitled to payment) when submitting the letter-of-credit claim. Phillips J held, *inter alia*, that in order to invoke the fraud exception "[t]hey must establish that, in drawing on the letters of credit, the [beneficiary] will be acting fraudulently in that they will be claiming payment to which they know they have no entitlement".[24] It seems, therefore, that English law was departing from, or at least watering down, the strict approach to the fraud exception as laid down by Lord Diplock in the *United City Merchants* case.[25] Although the injunction sought was eventually denied due to lack of evidence, the *Deutsche Ruckversicherung* case contributed to paving the way for a gradual openness towards accepting a wider notion of fraud. Furthermore, Enonchong argues that the *United City Merchants* case did not necessarily settle the question whether the fraud exception under English law is limited to forged or falsified documents:

> "The English courts have not yet decided the point. […] On the one hand, Lord Diplock's statement may be taken to mean that the exception is limited to fraud in the documents presented to the bank and does not extend to fraud in the wider transaction. On the other hand, as the case was concerned with fraud in a document and there was no argument on the question whether the exception extends to fraud in the transaction, it may be too much to say that Lord Diplock intended to confine the exception to fraud in the documents."[26]

Additionally, in the case of *TTI Team Telecom International Ltd v Hutchison 3G UK Ltd*,[27] the English courts had to decide a matter relating to an advance-payment transaction between two companies in the telecommunication industry which was secured by a demand guarantee. When the beneficiary of the guarantee threatened to call up the instrument, the applicant turned to the courts to interdict such a move, alleging the lack of material entitlement on the part of the beneficiary. Thornton J explained:

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[23] [1994] All ER 181 QBD. The subsequent appeal was dismissed in *Group Josi Re Co SA v Walbrook Insurance Co Ltd* [1996] 1 WLR 1152.

[24] (n 23 *1994*) 197E (alteration and insertion by me).

[25] See for instance the remarks of Oelofse "Developments in the law of documentary letters of credit" 1996 *SA Merc LJ* 56 64.

[26] (n 15) 101-102 par 5.17 (omission by me).

[27] [2003] 1 All ER (Comm) 914.

> "Only if the issuer is about to make payment to the beneficiary in circumstances where fraud, dishonesty or bad faith in relation to the demand is shown to exist or where the original issue of the documentary credit was procured by fraud or, possibly, where the underlying transaction was itself procured by fraud will a court intervene to restrain payment by the issuer to a beneficiary."[28]

The judgment in the *TTI Team Telecom* case departs from the notion that only falsified or manipulated documents, that is documentary fraud, can be captured under the fraud exception. Rather, Thornton J expressed the potential readiness of the English courts to assist an applicant or a guarantor if faced with a call on a guarantee, should such an instrument be called up in the circumstances mentioned in the quoted *dictum*. Analysing these particular findings, Enonchong therefore attested to the English law being likely "to accept that nowadays the fraud exception is not limited to fraud in the documents".[29]

5.2.3 Fraud as "no honest belief" in English law

There have been further indications by English judges reflecting a changing notion as to *what* constitutes fraud. Especially in the guarantee context it is important to take note of the emergence of the understanding that fraud may be defined as the submission of a claim under a guarantee which lacks the beneficiary's "honest belief" in the validity of such demand. This, naturally, differs considerably from the earlier interpretations of fraud being primarily the presentation of *documents containing false representations*. English courts have, over time, explored the idea that for a demand on an independent guarantee to be fraudulent, and thus able to be restrained through judicial intervention, the beneficiary must claim despite having "no honest belief" in the material entitlement or correctness of its demand. In *Benjamin's Sale of Goods*, the result of this development was summarised and contrasted with the fraud exception in letters of credit:

> "In the context of a documentary credit, fraud connotes the absence of an honest belief in the genuineness and validity of the *documents*. In the context of an autonomous guarantee, fraud connotes the absence of an honest belief in either the *entitlement* to claim under the guarantee or in the *amount* claimed."[30]

To demonstrate the accuracy of this comment, it is important to have regard to the English cases in which the judiciary pronounced on the ambit and understanding of the fraud

[28] par 31.

[29] (n 15) 103 par 5.19. The interpretation of Bridge *Benjamin's Sale of Goods* (2014) 2219 par 24-034, however, is that there is still no judicial authority clearly deciding this point.

[30] Bridge (n 29) 2211 par 24-023 (emphasis added by me).

exception, especially in light of the specific situations encountered in demand-guarantee transactions. In *Edward Owen Engineering Ltd v Barclays Bank International Ltd*,[31] Lord Denning held:

> "[…] performance guarantees are virtually promissory notes payable on demand. So long as the [beneficiaries] make an *honest demand*, the banks are bound to pay: and the banks will rarely, if ever, be in a position to know whether the demand is honest or not. At any rate they will not be able to prove it to be dishonest. So they will have to pay."[32]

Today, there are abundant examples of formulations in English case law describing the need for honesty for the demand to be valid, or, conversely, express the requirement of "no honest belief" for the fraud exception to apply.[33] In the well-known case *United Trading Corporation SA v Allied Arab Bank Ltd*,[34] Ackner LJ used the following words in relation to fraud in a demand-guarantee transaction:

> "[…] established that it is seriously arguable that, on the material available, the only realistic interference is that [the beneficiary] could not honestly have believed in the validity of its demands on the performance bonds".[35]

His formulation of the fraud exception as applicable to demand guarantees, was subsequently referred to with approval in several judgments.[36] In the *TTI Team Telecom* case,[37] referred to above, Thornton J held that:

> "Only if the issuer is about to make payment to the beneficiary in circumstances where fraud, dishonesty or bad faith in relation to the demand is shown to exist or where the original issue of the documentary credit was procured by fraud or, possibly, where the underlying transaction was itself procured by fraud will a court intervene to restrain payment by the issuer to a beneficiary."[38]

He went on to stress that "lack of good faith has for a long time provided a basis to restrain a beneficiary from calling a bond or guarantee".[39] Although this elaboration was more extensive on the issue in point, one can see the similarity to the two influential decisions in

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[31] [1978] QB 159.

[32] at 170-171 (insertions, omissions and emphasis by me).

[33] Note for instance *GKN Contractors Ltd v Lloyds Bank plc* [1985] 30 Building LR 48 (at 66) where "established dishonesty" and "active dishonesty" were said to be required (per Arnold P); and *National Infrastructure Development Co Ltd v Banco Santander SA* [2016] EWHC 2990 (Comm) (par 11 *et seq*).

[34] [1985] 2 Lloyd's Rep 554.

[35] 561 (alteration by me).

[36] For instance in *ESAL (Commodities) Ltd v Oriental Credit Ltd* [1985] Lloyd's Rep 546 (CA) (at 549-550), and in *Banque Saudi Fransi v Lear Siegler Services Inc* [2006] EWCA Civ 1130 (par 12 *et seq*), to name but two examples.

[37] n 27.

[38] par 31.

[39] par 34.

Edward Owen Engineering and *United Trading Corporation* in the choice of words "dishonesty or bad faith in relation to the demand". Another variation is found in *Banque Saudi Fransi v Lear Siegler Services Inc*,[40] where the court specified the test for fraud to entail "that [the beneficiary] could not honestly have thought that it had any basis for making any claim under the performance bond"[41] and that "there must be a real prospect of proving that the beneficiary could not honestly have believed in the validity of its demands on the performance bond".[42] The judges[43] also reiterated and cited the principles laid down in the *United Trading Corporation* case.[44] In *Uzinterimpex JSC v Standard Bank Plc*,[45] Steel J, with reference to demand guarantees, said that "a demand which the maker does not honestly believe to be correct as to its amount is a fraudulent demand".[46] And lastly and similarly, in *Alternative Power Solution Ltd v Central Electricity Board*,[47] the court held that for purposes of obtaining an interim injunction the inquiry ought to be whether "the only realistic inference is […] that the beneficiary could not honestly have believed in the validity of its demand".[48] In conclusion, it is suggested that the notion that the beneficiary must have an honest belief in the validity of its demand under an abstract guarantee, is now firmly established in English law.[49]

[40] n 36.

[41] par 19 (per Aden J – omissions and insertions by me).

[42] par 33 (per Pill J).

[43] par 12 *et seq*.

[44] *United Trading Corporation SA v Allied Arab Bank Ltd* (n 34).

[45] [2007] EWHC (1151).

[46] par 107 (per Steel J).

[47] [2014] UKPC 31.

[48] par 59 (per Clarke LJ – omission by me). Although the judgment was concerned with the potential abuse of a letter of credit, the rule can clearly be transposed to a demand-guarantee transaction.

[49] McKendrick *Goode on Commercial Law* (2010) 1139 (see also the various cases in his n 348); Ellinger and Neo *The Law and Practice of Documentary Letters of Credit* (2010) 309 par A; Enonchong (n 15) 106 par 5.30; Brindle and Cox *The Law of Bank Payments* (2010) 838-839; and Rodrigo "Toward fairness in the guarantee market: the rationale for expanding interventions from fraud to unconscionability in the enforcement of demand guarantees" 2013 *International Trade and Business Law Review* 225 232 *et seq*.

5.2.4 Fraud in South African law

In South Africa the fraud exception has been recognised in the law of demand guarantees and letters of credit.[50] This exception to the principle of independence was first mentioned in *Phillips v Standard Bank of South Africa Ltd*.[51] Although fraud was not alleged by the parties in that case,[52] Goldstone J made reference to *Sztejn v J Henry Schroder Banking Corporation*[53] and the later case of *United City Merchants (Investments) Ltd v Royal Bank of Canada (The American Accord)*[54] in his judgment.[55] Because of the absence of allegations of fraud by the applicant, Goldstone J stated "[w]hether, and to what extent, and in what circumstances, our Courts would or should recognize this 'one established exception' is therefore unnecessary for me to consider, and I expressly refrain from doing so".[56] However, he continued to declare that "the *dicta* I have cited from *Sztejn* and the *Royal Bank of Canada* cases appear to me to correctly reflect our law",[57] thus, arguably,[58] showing cautious sympathy for the fraud exception in South African law.

The definite endorsement of the fraud exception came a decade later in *Loomcraft Fabrics CC v Nedbank Ltd*.[59] In this letter-of-credit case, Scott AJA (with Corbett CJ, Hefer JA, Nestadt JA and Harms JA concurring) declared:

> "Nonetheless, it is now well established that a Court will grant an interdict restraining a bank from paying the beneficiary under a credit in the event of it being established that the beneficiary was a party to fraud in relation to the documents presented to the bank for payment."[60]

Oelofse described this as a "first brush with the autonomy principle and its limits",[61] and other South African commentators have remarked in the same vein.[62] Not only did *Loomcraft*

[50] See also par 3.4.2.5 above.

[51] 1985 (3) SA 301 (W).

[52] 303I-J.

[53] n 10.

[54] n 17.

[55] 303A-J.

[56] 304A (alteration by me).

[57] 304B.

[58] On the other hand, Oelofse *The Law of Documentary Letters of Credit in Comparative Perspective* (1997) 464-465 does not agree with this assessment. For a similar opinion, see Kelly-Louw (n 6) 325; and, to a lesser extent, Kelly-Louw "Limiting exceptions to the autonomy principle of demand guarantees and letters of credit" in Visser and Pretorius *Essays in Honour of Frans Malan* (2014) 197 201.

[59] 1996 (1) SA 812 (A).

[60] 817E-F.

Fabrics CC v Nedbank Ltd formally introduce the fraud exception to the South African law relating to letters of credit, but it was also seen as having shown clear appreciation for the narrowly confined fraud exception.[63] However, the question whether South African law favours the narrow or the wider fraud exception, was not determined finally in this judgment. In this regard it is of importance to take note of another judgment, which provides some guidance on this particular point. In *Union Carriage and Wagon Company Ltd v Nedcor Bank Ltd*,[64] the Witwatersrand Local Division was concerned with an appeal on a letter-of-credit and guarantee case.[65] The applicant contended that the beneficiary had – in the underlying contract – bound itself not to draw on the letter of credit before a certain event.[66] This (implied) agreement,[67] if ever validly concluded between the parties, was in any event not contained in the letter of credit itself. Wunsh J, with Eloff JP and Ginsburg AJ concurring, eventually did not have to evaluate this (implied) agreement stemming from the underlying contract,[68] but remarked by way of an *obiter dictum*:

> "If there was such an agreement [in the underlying contract], and it is not alleged in this case, and the beneficiary knowing that it had given such an undertaking nevertheless sought to exact payment under the letter of credit, it could conceivably be guilty of fraud. I express no opinion, because it is not necessary to do so."[69]

This, it is suggested, constitutes a remarkable judicial comment on the concept of fraud. In a conference submission, Ally observed that

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[61] Both in Oelofse (n 58) 470 par 9.4.6.3, as well as Oelofse (n 22) 12.

[62] Kelly-Louw (n 58 *2014*) 201 ("first real opportunity"); and Kelly-Louw (n 6) 325.

[63] Kelly-Louw (n 58 *2014*) 202; Kelly-Louw (n 6) 328; and Oelofse (n 58) 472 and 477. But note Van Niekerk and Schulze (n 21) 296 for an opposing view. Van Niekerk and Schulze, incidentally, seem to be in substantial agreement with Enonchong (n 15) 101-102 par 5.17, where he comments on Lord Diplock's decision in the *United City Merchants* case (see par 5.2.2 above).

[64] 1996 CLR 724 (W).

[65] Although termed letters of credit, the security instruments under consideration in this case were actually performance guarantees/advance payment guarantees, rather than commercial letters of credit.

[66] Unfortunately, in the judgment (735) it is described as a "pactum de non *cedendo*" (emphasis is mine), whereas the agreement under discussion would have been a "pactum de non *petendo*". For an in-depth discussion of the case, see Oelofse (n 58) 474-477 and Oelofse "Developments in the law of documentary letters of credit" 1997 *Annual Banking Law Update* 1 6-7.

[67] Such an agreement or clause which restricts or qualifies the beneficiary's right to draw on a letter of credit, or to call up a demand guarantee, is commonly referred to as a "negative stipulation". Negative stipulations are dealt with in more detail in chapter 7 below.

[68] 735.

[69] 735 (insertion by me).

> "[it] does not constitute binding law, [but] nevertheless has considerable persuasive value. More importantly, it serves to prevent a dishonest beneficiary from benefiting from his fraudulent conduct."[70]

Largely, the *Union Carriage* case was perceived as cautiously supporting the wider fraud exception in South African law,[71] a move which was welcomed by scholars. For example, Kelly-Louw argues:

> "Concerning the fraud exception it should not matter at all whether the fraud relates to the documents (fraud in the narrow sense) or is committed in respect of the underlying contract by the beneficiary (fraud in the wide sense). As long as the fraud is committed by the beneficiary and clearly established it should suffice as a ground to prevent payment from taking place."[72]

5.2.5 Fraud as "knowledge of lack of entitlement" in South African law

In addition to adopting the "wide" fraud exception described above, courts in South Africa have recently been moving towards a particular concept of fraud in demand guarantees similar to that held in English law. Akin to the absence of an "honest belief" regarding the substantial entitlement to payment, as in English law, the SCA stated in *Guardrisk v Kentz*:[73]

> "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."[74]

With this statement Theron JA made it clear that South African law has moved away from the notion of fraud being mere documentary fraud. This *dictum* indicates that the lack of an "honest belief" on the part of the beneficiary as to its material entitlement to sums promised under the guarantee may defeat the independence principle.[75] Correspondingly, Cloete J in

[70] Ally "The legal nature of documentary letters of credit in international trade: a South African law perspective" in Delener, Fuxman, Lu, and Rivera-Solis *Fulfilling the Worldwide Sustainability Challenge: Strategies, Innovations, and Perspectives for Forward Momentum in Turbulent Times* (2011) 13 16 (alteration and insertion by me).

[71] Van Niekerk and Schulze (n 21) 296; Kelly-Louw (n 58 *2014*) 203-204; Kelly-Louw (n 6) 332; and Oelofse (n 66 *Annual Banking Law Update*) 7 par 4.

[72] (n 58 *2014*) 216. Note, however, that her remarks were not made specifically in relation to *Union Carriage and Wagon Company Ltd v Nedcor Bank Ltd*, but rather towards the South African legal position in general.

[73] [2014] 1 All SA 307 (SCA).

[74] par 17 (per Theron JA – emphasis is mine).

[75] This view also alignes with the reasoning of Opperman AJ who chose the expression "real, genuine or bona fide dispute of fact" and "genuine dispute" in order to *deny* allegations of fraud in *Phenix Construction Technologies (Pty) Ltd v Hollard Insurance Company Limited* [2015] ZAGPJHC 282 (10 December 2015) par 33.

Scatec Solar SA 163 (Pty) Ltd v Terrafix Suedafrika (Pty) Ltd[76] summarised the crucial test as follows:

> "[…] the question is whether [the director of the beneficiary company] *knew* when he presented the demands for payment to [the issuing bank] that [the beneficiary] was in fact *not entitled to payment* in terms of the relevant invoices, but he nonetheless intentionally went ahead and deliberately represented to [the issuing bank] that the amounts were due."[77]

Earlier, and during the same litigation, he can be understood as having already expressed sympathy for the "knowledge of lack of entitlement" approach.[78] Although apparently preferring different terminology and thus phrasing it differently, Satchwell J in *Group Five Construction (Pty) Limited v Member of the Executive Council for Public Transport Roads and Works Gauteng*,[79] also displayed appreciation for a similar understanding of the law. She concluded in her judgment:

> "Absence of good faith as ground for declining enforcement of a guarantee has received support from the Supreme Court of Appeal in the minority judgement of Cloete JA in [*Dormell Properties*] as also in [*Guardrisk v Kentz*], *Scatec Solar SA 163 (Pty) Ltd v Terrafix Suedafrika (Pty) Ltd* [2014] ZAWCHC 24 […]."[80]

Nevertheless, because this particular issue of interpretation has only recently begun receiving judicial attention in South Africa, it would be prudent to conclude that the South African law in this regard may still be developing.[81] This gradual change in judicial interpretation and legal understanding as to *what* comprises fraud, is to be welcomed. This is not only because it adapts the established notions of fraud as an exception to the principle of independence to the particular and specific situations and requirements under demand guarantees,[82] but also in the sense of reflecting South Africa's motivation and willingness to modernise and align its domestic law and understanding with international trends.[83]

[76] [2014] ZAWCHC 63 (25 April 2014).

[77] par 23 (insertions, added emphasis and omissions by me). The case was essentially concerned with demand guarantees but uses the terminology "standby letters of credit" and also simply "letters of credit".

[78] See his remarks in the *Scatec* case (n 76) par 28 (with references to, *inter alia*, *Rex v Myers* 1947 1 SA 375 (AD)).

[79] [2015] ZAGPJHC 55 (13 February 2015). For a discussion of the case see Kelly-Louw and Marxen "General update on the law of demand guarantees and letters of credit" 2015 *Annual Banking Law Update* 276 294-295.

[80] par 50 (alteration and omission of her last reference by me).

[81] Kelly-Louw (n 58 *2014*) 204.

[82] See par 5.2.6 *et seq* below.

[83] See Hugo "Construction guarantees and the Supreme Court of Appeal (2010 – 2013)" in Visser and Pretorius *Essays in Honour of Frans Malan* (2014) 159 162.

5.2.6 The fraud exception and demand guarantees: applicability and suitability

At this point, the merits of the different ambits and concepts of the fraud defence exception should be evaluated with particular reference to demand guarantees. In order to elaborate, the interesting question of applicability and suitability of the fraud exception, as derived from letters-of-credit law, to the field of demand guarantees needs to be investigated. One should appreciate the different manners in which demand guarantees and commercial letters of credit are utilised, the way payment is usually triggered, and the functions which the two different instruments serve in commercial activities. Also, the role of the *guarantor*, as opposed to the *issuer* of a letter of credit, should be taken into account.

As was described above,[84] letters of credit and demand guarantees share certain fundamental properties. Both are subject to the principle of independence, which ensures the detachment of the underlying contract (for instance a contract of sale, or a construction contract) from the obligations under the instrument itself. Therefore, the obligation assumed by the guarantor or issuer is independent of the underlying relationship of the parties. The right to demand payment under a letter of credit is to be assessed without reference to the underlying contract of sale, and depends only on the documentary conditions set forth in the instrument itself. The same must be said about the beneficiary of a demand guarantee: the right to call on the guarantee is determined with sole reference to the guarantee and stipulations captured therein; the underlying contract between the applicant and the beneficiary is immaterial at this stage. Also, the release of monies promised under the instruments is dependent on presentation of compliant documents. Hence the two instruments are largely comparable. As stated in *Benjamin's Sale of Goods*: "In law, therefore, an autonomous guarantee mirrors a letter of credit in the assumption of a primary liability to pay against presentation of the documents specified in the instrument."[85]

Demand guarantees and documentary credits: important differences

However, there are also decisive differences between letters of credit and demand guarantees. For this reason caution was advised by Parker LJ in the English case of *GKN Contractors Ltd v Lloyds Bank plc*: "Transactions by way of performance guarantee are similar to, albeit not

[84] See par 3.4 *et seq* above.

[85] Bridge (n 29) 2199 par 24-001.

identical with, transactions under confirmed letters of credit. The analogy cannot, however, be pressed too far […]."[86] First of all, the commercial purpose and the functions of the two instruments differ and warrant recapitulation.[87] While letters of credits are utilised as a reliable means of *payment* in international trade, the demand guarantee rather secures the proper performance of a contractual obligation and fulfils a *security* function.[88] *Benjamin's Sale of Goods* puts it thus:

> "[A] letter of credit is concerned with performance, an autonomous guarantee with non-performance. It is expected that payment will be made under a letter of credit; it is hoped that no payment will be claimed under an autonomous guarantee."[89]

Accordingly, the calling-up of a letter of credit is intended by all parties as it implies the proper dispatch of goods by the seller; such a demand is in line with the notion of the payment function which the documentary credit performs. Calls on commercial letters of credit are the normal practice in international trade and business,[90] as pointed out above.[91] Accordingly, Ellinger and Neo[92] explain that "[i]n a commercial letter of credit, the parties intend that the seller should look, in the first instance, to the issuing bank rather than the buyer when he seeks payment for the goods". Conversely, the demand under a guarantee suggests failure of proper performance, and such a demand by the beneficiary is only expected in cases of breach of the underlying contract.[93] Thus, the security aspect of demand guarantees becomes evident.

This difference may conceivably merit the argument that interference with the independence principle in a demand guarantee could be more permissible than an inroad into the independence of a letter of credit, the reason being that a beneficiary of a letter of credit is

[86] *GKN Contractors Ltd v Lloyds Bank plc* (n 33) par 62, with Arnold P concurring in par 66 – omission by me.

[87] See par 3.5 above.

[88] Hugo (n 83) 160; McKendrick (n 49) 1129; Affaki and Goode *Guide to ICC Uniform Rules for Demand Guarantees URDG 758* (2011) 9 par 19; Canaris, Habersack and Schäfer *Staub Handelsgesetzbuch Zehnter Band Zweiter Teilband* (2015) 365 par 559 (regarding letters of credit, "die Funktion als Zahlungsmittel ist sogar die primäre"); and Lehtinen "Demand guarantees in construction contracts: the Finnish perspective" 2010 *The International Construction Law Review* 511 514.

[89] Bridge (n 29) 2199 par 24-001 (alteration by me).

[90] Graf von Westphalen and Zöchling-Jud *Die Bankgarantie im internationalen Handelsverkehr* (2014) 614 par 47; and Affaki and Goode (n 88) 9 par 19.

[91] See par 3.5 above.

[92] (n 49) 308 (alteration by me).

[93] Adodo *Letters of Credit the Law and Practice of Compliance* (2014) 25 par 1.60; Graf von Westphalen and Zöchling-Jud (n 90) 614 par 48; Wooler "The new 'Asplenium Clause' – unconscionability unwound?" 2016 *Singapore Journal of Legal Studies* 169 175; and Mugasha (n 15) 59.

deprived of all the payment assurance should the independence principle be limited or infringed upon. Its "first port of call", as McKendrick called it,[94] would be denied and it would have to turn to the buyer and pursue its claim for payment stemming from the underlying contract of sale. Such a situation would clash with the original intentions of the parties, who deliberately opted for payment and security by letter of credit. The image of the letter of credit being the "life-blood of international commerce"[95] would be tainted, and "[t]hrombosis will occur"[96] as Donaldson LJ phrased it.[97] A call on a demand guarantee, in contrast, is more rare.[98] Obviously, the beneficiary must have anticipated *some* unlikely situation in which a call on the guarantee would be necessary, as otherwise the initial request to furnish a guarantee would not have taken place. Typically, however, the parties perceive the likelihood of an actual demand on the guarantee to be low.[99]

Primary and secondary obligations

More importantly, a demand guarantee (a construction guarantee, for example) typically covers only the *secondary* obligations of the applicant stemming from the underlying contract, and not the *primary* obligations as in the case of a letter of credit.[100] The guarantee simply secures the obligation of the applicant to pay damages if it fails to perform in accordance with the underlying contract. The need to call up the guarantee arises only if performance is defective or insufficient in order to support or replace a claim for damages.[101]

[94] (n 49) 1055 and 1129.

[95] *RD Harbottle (Mercantile) Ltd v National Westminster Bank Ltd* [1977] 2 All ER (QB) 862 870b (per Kerr J).

[96] *Intraco Ltd v Notis Shipping Corp (The "Bhoja Trader")* [1981] 2 Lloyd's Rep 256 257 (alteration by me).

[97] Loh and Wu "Injunctions restraining calls on performance bonds – is fraud the only ground in Singapore?" 2000 *LMCLQ* 348 351 describe the thrombosis argument as "dramatic".

[98] Lehtinen (n 88) 511; and the "Diskussionsbericht zu den Referaten Coing und Nielsen" 1983 *Zeitschrift für das gesamte Handelsrecht und Wirtschaftsrecht* (*ZHR)* 162.

[99] Note, for example, Mugasha (n 15) 59.

[100] Bridge (n 29) 2200 par 24-001; and McKendrick (n 49) 1129. However, it is also important to note the practice in certain business transactions of utilising so-called financial or direct-pay standby letters of credit, which are employeed as a regular means of effecting payment. In such cases the arguments advanced here are not applicable. This discussion, therefore, does not relate to such instruments.

[101] See for instance Malek and Quest (n 15) 337 par 12.3 (1). In Bridge (n 29) 2200 par 24-001 it was argued that letters of credit and demand guarantees "may respond to different levels of obligation of the underlying contract: a payment credit to the buyer's primary obligation to pay for the goods, a guarantee to the seller's secondary obligation to pay damages for breach of contract".

Hence it can be argued that interference with the principle of independence in demand guarantees, and the broadening of the fraud exception by widening its scope, may be more permissible than in the case of a letter of credit;[102] it is typically a mere secondary obligation which is affected. In a Singaporean judgment, Chan J held:

> "A performance guarantee does not perform the same function as a documentary letter of credit in international trade, nor does it cause the same degree of hardship to the party concerned if a temporary restraining order is granted. […] A temporary restraining order does not affect the security nor the beneficiary's right in it. It merely postpones the realisation of the security until the plaintiff is given the opportunity to prove his case."[103]

This is an important observation, putting emphasis on the issue of primary and secondary nature of the concerned obligations.

Required documents

Apart from the different functions of letters of credit and demand guarantees, the documents triggering payment under them differ significantly. Typically, the documents stipulated for in a letter of credit point to the actual execution of the underlying agreement, for instance clean bills of lading, insurance policies, quality certificates, warehouse receipts and packing lists. It is important to note that these documents are predominately third-party documents, necessitating the involvement of "outside" parties like shipping agents, carriers, warehouses and insurance companies. With the exceptions of perhaps packing lists and commercial invoices, the beneficiary is therefore reliant on parties outside the underlying contract to furnish the documents. Furthermore, some of the documents, especially bills of lading and insurance documents, may be seen as representing the goods and claims relating to them. It is occasionally said that the issuer of a letter of credit acquires mostly third-party documents when honouring a claim, and therefore gives money for "valuable paper" in exchange.[104] Thus, even in the case of some or other questionable conduct by the beneficiary, the issuer, by honouring the credit, obtains documents representing some value.

[102] See, for example, the remarks of Crangle "Resistance is futile? Performance bonds and how payment under them can be stopped" (presentation at the Society of Construction Law conference, Leeds 13 March 2012) 1 13.

[103] *Chartered Electronic Industries Pte Ltd v The Development Bank of Singapore Ltd* [1999] 4 SLR 665 668 (omission by me).

[104] Debattista "Performance bonds and letters of credit: a cracked mirror image" 1997 *The Journal of Business Law* 289 303.

Demand guarantees, on the other hand, often stipulate, along with the demand itself, only for a simple written assertion by the beneficiary that the applicant has defaulted on its contractual obligations and that the underlying contract has been cancelled.[105] But one must also look at international rules in this particular regard. For example, the URDG 758 set out the default requirements for a complying demand as follows:

> "A demand under the guarantee shall be supported by such other documents as the guarantee specifies, and in any event by a statement, by the beneficiary, indicating in what respect the applicant is in breach of its obligation under the underlying relationship. This statement may be in the demand or in a separate signed document accompanying or identifying the demand."[106]

Therefore, if a guarantee is subject to the URDG 758, and does not contain further conditions, a demand in writing, with a declaration that the applicant has breached its contractual obligations in a particular respect, would suffice to compel the guarantor to pay. Documentary proof originating from third parties is mostly not required. Hence, when a complying demand is submitted to the guarantor, it will have to pay against documents which do not hold any intrinsic value, or embody rights against third parties;[107] a simple "say-so statement" emanating from the beneficiary would suffice.[108] So viewed it is clear that the potential exposure of a guarantor to fraud is significantly higher than that of an issuer of a documentary credit. For that reason, too, it can be argued that the adoption of the wider fraud exception is justified in the case of guarantees.

In any event, the narrow approach focusing only on fraud in the documents cannot apply to demand guarantees in a meaningful and effective way. As Bertrams stated: "[c]ompared with documentary credits, fraud in the form of forged or fraudulent documents

[105] *University of the Western Cape v ABSA Insurance Company Ltd* [2015] ZAGPJHC 303 (28 October 2015); *Kristabel Developments (Pty) Ltd v Credit Guarantee Insurance Corporation of Africa Limited* [2015] ZAGPJHC 264 (20 October 2015); *Group Five Construction (Pty) Limited v Member of the Executive Council for Public Transport Roads and Works Gauteng* (n 79); *Coface South Africa Insurance Co Ltd v East London Own Haven t/a Own Haven Housing Association* 2014 (2) SA 382 (SCA); and *Compass Insurance v Hospitality Hotel Developments (Pty) Ltd* 2012 (2) SA 537 (SCA). See also Hugo (n 83) 161-162; Horowitz (n 21) 83 par 5.03; Davis *Refund Guarantees* (2015) 8 par 2.33; O'Donovan and Phillips *The Modern Contract of Guarantee* (2010) 889-890; Fedotov "Abuse, unconscionability and demand guarantees: new exception to independence" 2008 *International Trade and Business Law Review* 49 52 ("minimal documentary requirements"); Wood *International Loans, Bonds, Guarantees, Legal Opinions* (2007) 386 par 21-009; and Goode *Payment Obligations in Commercial and Financial Transactions* (1983) 49.

[106] art15 a.

[107] See for instance Fedotov (n 105) 58; Debattista (n 104) 303-304; and Coleman "Performance guarantees" 1990 *LMCLQ* 223 229.

[108] *Kristabel Developments (Pty) Ltd v Credit Guarantee Insurance Corporation of Africa Limited* (n 105) par 30 (per Satchwell J). See also Longmore LJ in *Meritz Fire and Marine Insurance Co Ltd v Jan de Nul NV* [2011] EWCA Civ 827 par 19.

is of minor significance."[109] As a consequence, fraudulent conduct by the beneficiary relating to the underlying contract must be regarded as relevant. Hence the recognition of fraud as an absence of an "honest belief" in English law, or proof of obvious "knowledge of the lack of entitlement" in the South African law, is to be welcomed. It is far better tailored to the guarantee situation.

In conclusion, therefore, the case for the recognition of the wide fraud exception is stronger in relation to guarantees than in relation to letters of credit, for two reasons: first, a call on a letter of credit is a regular and anticipated event, while a call on a demand guarantee is rare; and secondly, a documentary credit is used as the principal medium for payment and thus fulfils a primary contractual obligation, whereas a demand guarantee as security instrument fulfils a secondary function. Also, the necessary documents needed to trigger payment typically differ as was discussed above. In order to safeguard against fraudulent conduct by a beneficiary it is reasonable to argue that the narrow fraud exception, although probably fitting for letters of credit, is inadequate in regard to demand-guarantee transactions.

While the academic debate regarding the precise extent of the fraud exception is still ongoing,[110] it is safe to state that there are many proponents for the adoption of the wide fraud exception for demand guarantees – a step which both English and South African law have taken. Horowitz, for example, rejects the narrow approach focusing on pure documentary fraud as "inappropriate"[111] and "difficult to apply to demand guarantees"[112]. This is supported by Enonchong who puts it thus:

> "Since performance bonds do not normally require the presentation of documents other than the written demand and the beneficiary's statement of default, if the exception were confined to fraud in documents presented, its scope would have been so narrow as to make it truly illusory."[113]

This, too, is the view that has attained the upper hand in English case law. The *TTI Team Telecom* and the *Deutsche Ruckversicherung* case were especially important in this regard. English courts are now clearly prepared to look beyond the documents and consider the underlying relationship and the beneficiary's conduct relating thereto in order to prevent abusive calls on demand guarantees. In South Africa such an approach was already evident in

[109] (n 7) 353 (alteration by me).

[110] Kelly-Louw and Marxen (n 79) 300.

[111] (n 21) 30 par 2.20.

[112] (n 21) 127 par 5.65.

[113] (n 15) 101 par 5.16.

the early case of *Union Carriage and Wagon Company Ltd v Nedcor Bank Ltd* and the *obiter dictum* by Wunsh J. Recent support for the view is to be found in the *Guardrisk v Kentz* case,[114] albeit still somewhat oblique. The clear recognition of fraud as the "knowledge of lack of entitlement" under South African law, is the logical next step.

5.2.7 Summary: fraud in English and South African law of demand guarantees

It is evident from the above that the fraud exception has developed both in English and South African law from a point of deparature emphasising decoumentary fraud to a wider approach focussing on the question whether the beneficiary honestly believes it is entitled to payment. This means that the beneficiary's actual conduct in relation to the entire transaction, including therefore the underlying contract, is emerging as the central issue. It is against this background that the question as to what exactly qualifies as fraud must be approached.

5.2.8 Excursus: fraud in the context of retention money guarantees

Before examining the German approach based on the *Rechtsmissbrauch* doctrine, one vexing question relating to a particular manifestation of fraud in the context of retention money guarantees[115] merits attention. Instead of retaining monies due under the underlying construction contract, the employer will, upon receiving the guarantee, release all the payments in full to the contractor. The guarantee, therefore, effectively takes the place of the retention fund. As the construction contract progresses different stages of completion are reached and accordingly certified.[116] Should a demand on the guarantee be made *before* the issuance of the final certificate, the issue of potential abuse arises. The question is whether it is abusive or fraudulent for the employer to call up the full sum guaranteed despite the fact that the final payment certificate has not yet been issued. The problem in this regard is that the call is in excess of the amount the original retention fund would have held in the absence

[114] n 73.

[115] Regarding retention money guarantees, in general, see par 4.3.6 above. Defences to demands for payment based on the terms of the guarantee in relation to retention money guarantees are discussed in par 6.5 below.

[116] For certification in the construction industry, see par 5.4.2 below.

of it having been replaced by the guarantee. Elaborating on retention money guarantees Kelly-Louw[117] states:

> "However, the employer may be willing to release such retention moneys against a retention guarantee securing repayment of the *released retention moneys* if defects are later found or if the contractor fails to complete the contract."

If one emphasises the purpose of the retention guarantee to secure repayment of the *released money*, there is room for the argument that only the previously retained and subsequently released amount should be available under the guarantee.[118] Only monies which would have been available had the parties opted for the classic retention fund should, so viewed, be claimed under the guarantee by the beneficiary.[119] This approach draws a functional parallel between the retention fund and the retention money guarantee.

In accordance with the independence principle, however, the guarantee has to be complied with as any other demand guarantee.[120] Therefore, the imperative stemming from the independence principle to honour a demand guarantee according to its terms, without reference to the underlying relationship, may justify the argument that the fact that only some payment or certification stages have been reached, is irrelevant.

Approached from the perspective of the fraud defence, and specifically with the view that fraud as a defence does not only relate to "fraud in the documents", but in the case of a demand guarantee also to "fraud in the underlying transaction", "fraud in the wider sense" or fraud as the submission of a demand without an "honest belief",[121] the issue of fraud could tie in with the previous elaboration. If the beneficiary submits a demand under the guarantee in full, and in breach of the underlying contract, one could contend the beneficiary to be guilty of fraud, and thus interdictable by the beneficiary. This would necessitate, however, that the beneficiary is not entitled, materially speaking with regard to the underlying contract, to collect the full amount even though only parts of the completion stages have been reached.

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[117] (n 6) 38 par 2.4.2.4 (emphasis is mine).

[118] See Bertrams (n 7) 413 par 14-52; and note also the remarks of Haynes *The Law Relating to International Banking* (2010) 279 par 10.15. At this point it is important to note that Kelly-Louw did *not necessarily* subscribe to this argument.

[119] See, for instance, the remarks in Horn and Wymeersch (n 1) 73.

[120] *Nedbank v Procprops* [2013] ZASCA 153 (20 November 2013) at 9 per Van der Merwe AJA; *First Rand Bank v Brera* 2013 (5) SA 556 (SCA) at 2 per Malan JA; *Lombard Insurance Company Ltd v Landmark Holding (Pty) Ltd* 2010 (2) SA 86 (SCA) par 20 per Navsa JA; and *Basil Read (Pty) Ltd v Nedbank Ltd* [2012] ZAGPJHC 101 at 26-29 per Saldulker J.

[121] See par 5.2.2 *et seq* above.

This could be the case if a demand on the guarantee in excess of what would be due under a retention fund would be disallowed in terms of the underlying construction contract, especially considering the notion of the functional parallel as explored above. As was shown above,[122] fraud as a defence against the call on a demand guarantee may relate to the question whether the beneficiary holds an "honest belief" in the validity of its demand, and whether the beneficiary must be seen as having had "knowledge of lack of entitlement" when calling up the guarantee. If the beneficiary chooses to ignore the restriction imposed by the underlying agreement (if there are such restrictions),[123] and submits a demand under the guarantee in full one could contend the beneficiary to be acting abusively.

Therefore, an applicant could decide to resort to the fraud exception,[124] under the premise that the beneficiary's lack of "honest belief" in the validity, and material basis, of its claim would persuade the court to declare the demand fraudulent, and thus defeat the independence principle.

5.2.9 The German approach: doctrine of *Rechtsmissbrauch* (abuse of rights)

Conceptually the position under German law and its engagement with fraudulent and abusive calls on demand guarantees in general, is very different.[125] In German law the concept of *Rechtsmissbrauch* (abuse of rights; also referred to as *Rechtsmissbrauchsverbot*, prohibition of abuse of rights) plays a pivotal role. The doctrine in the context of letters of credit and demand guarantees was derived from certain paragraphs of the "Bürgerliches Gesetzbuch (BGB)",[126] for instance paragraph 138 (*Sittenwidriges Rechtsgeschäft; Wucher*),[127] paragraph 158 (*Aufschiebende und auflösende Bedingung*),[128] paragraph 162 (*Verhinderung oder*

[122] See par 5.2.7 above.

[123] Negative stipulations and restrictions in the underlying contract are discussed in detail in chapter 7 below.

[124] However, note also the discussion regarding defences based on the terms of the guarantees in relation to retention money guarantees (par 6.5 below).

[125] On this particular point, see Lohmann *Einwendungen gegen den Zahlungsanspruch aus einer Bankgarantie und ihre Durchsetzung in rechtsvergleichender Sicht* (1984) 102 par 1.1.

[126] German Civil Code.

[127] "Legal transaction contrary to public policy; usury" (all BGB translations by the Langenscheidt Translation Service, www.gesetze-im-internet.de/englisch_bgb).

[128] "Conditions precedent and subsequent".

Herbeiführung des Bedingungseintritts),[129] paragraph 226 (*Schikaneverbot*),[130] paragraph 826 (*Sittenwidrige vorsätzliche Schädigung*)[131] and, most importantly, the "good faith" imperative in paragraph 242 (*Leistung nach Treu und Glauben*).[132]

According to the notion of *Rechtsmissbrauch* a beneficiary may not demand payment under such an instrument if there is immediate and clear proof that the demand would constitute an obvious abuse of formal rights.[133] The *Bundesgerichtshof (BGH)*, Germany's highest court in civil matters, regularly uses the expressions "offensichtlich oder liquide beweisbar"[134] and "mißbräuchliche Ausnutzung einer formalen Rechtsstellung durch den Begünstigten klar erkennbar"[135] to emphasise the high standard[136] for obviousness and accessibility of allegations of abusive behaviour. Bertrams paraphrases the requirement for "offensichtlich und liquide beweisbar" as "clear, evident, beyond doubt, unambiguous and immediately available",[137] while others have suggested "clearly established, apparent and obvious",[138] or "blatant".[139] The party seeking judicial intervention or reliance on the doctrine

[129] "Prevention of or bringing about the satisfaction of the condition".

[130] "Prohibition of chicanery".

[131] "Intentional damage contrary to public policy".

[132] "Performance in good faith". See Graf von Westphalen and Zöchling-Jud (n 90) 206-214 par 208-223; Heidbüchel (n 5) 210-211 par a; Blesch and Lange *Bankgeschäfte mit Auslandsbezug* (2007) 164-165 par 557; Mülbert *Mißbrauch von Bankgarantien und einstweiliger Rechtsschutz* (1985) 50-59; Lohmann (n 125) 17-21; Nielsen "Rechtsmißbrauch bei der Inanspruchnahme von Bankgarantien als typisches Problem der Liquiditätsfunktion abstrakter Zahlungsversprechen" 1982 *Zeitschrift für Wirtschaftsrecht und Insolvenzpraxis (ZIP)* 253 258-259; Lehmann *Vindikation und richterlicher Wertungsspielraum* (2011) 137-138; Panagiotopoulos *Die Rückforderung unbegründeter Zahlungen bei einer Bankgarantie 'auf erstes Anfordern'* (2007) 225; Horn and Wymeersch (n 1) 27; Mahler *Rechtsmißbrauch und einstweilliger Rechtschutz bei Dokumentenakkreditiven und 'Akkreditiven auf erstes Anfordern'* (1986) 77 and 80-90; Coing "Probleme der internationalen Bankgarantie" 1983 *Zeitschrift für das gesamte Handelsrecht und Wirtschaftsrecht (ZHR)* 125 131 and 139; and Horn "Bürgschaften und Garantien zur Zahlung auf erstes Anfordern" 1980 *NJW* 2153 2156 par 3. Further, note the interesting comments in Zimmermann *Das Rechtsmißbrauchsverbot im Recht der Europäischen Gemeinschaften* (2002) 115 *et seq*.

[133] OLG Stuttgart 10 U 102/14 (20.01.2015) (juris) par 30 and 32.

[134] BGH 2011 *WM* 2216; BGH *BGHZ* 145, 286 291; BGH *BGHZ* 140, 49 51-52; and BGH *BGHZ* 90, 287 292. Although dealing with the recognition of claims qualifying for a set-off in a demand guarantee setting, see also BGH *BGHZ* 94, 167 173 ("liquide Ansprüche").

[135] Apparent and obvious abuse of a formal right by the beneficiary, BGH 1989 *WM* 433 434; and BGH (n 134 *BGHZ 145*) 291.

[136] Commentators used the expression "hohe Anforderungen": see Lwowski, Fischer and Langenbucher *Das Recht der Kreditsicherung* (2011) 345 par 221.

[137] (n 7) 358.

[138] Hugo and Marxen "Documentary credits and independent guarantees" 2013 *Annual Banking Law Update* 25 33.

[139] See Horn and Wymeersch (n 1) 28 (n 149).

as a defence to payment claims, therefore, has to offer conclusive and immediate proof of abusive conduct, usually of documentary nature.[140]

Should the dispute or the allegations relate to questions of fact or law which cannot be answered immediately with sufficient certainty and mere reference to the furnished proof, they must be argued out later after payment under the instrument has been made.[141] The *Bundesgerichtshof* used the expression "erst zahlen – dann prozessieren"[142] to illustrate this rule.

According to German law and its doctrine of *Rechtsmissbrauch* payment under a demand guarantee may be resisted if the demand *formally* complies with the conditions set forth in the instrument (*formeller Garantiefall*), while the beneficiary would be acting abusively because of its clear lack of *substantial* or *material* entitlement (*Ausbleiben des materiellen Garantiefalls*).[143] German law, therefore, places significant emphasis on the divergence of formal entitlement on the one hand (the beneficiary submits formally complying documents), and the lack of material, substantial entitlement on the other hand (obvious and evident lack of entitlement on the merits of the underlying relationship). Obviously, the doctrine *per se* infringes upon the idea of strict separation between the guarantee transaction (the contract between the guarantor and beneficiary), and the underlying relationship (the contract between the applicant and beneficiary) – to the benefit of fairness, equity and material justice as it enables the parties concerned to counter fraudulent and otherwise abusive conduct.

[140] Graf von Westphalen and Zöchling-Jud (n 90) 202-205 par 200-206; Derleder, Knops and Bamberger *Handbuch zum deutschen und europäischen Bankrecht* (2009) 1878 par 85; Edelmann "Blockierung der Inanspruchnahme einer direkten Auslandsgarantie" 1998 *Der Betrieb* (*DB)* 2453; Coing (n 132) 130-131; and Nielsen (n 132) 260. Note, however, the criticism levelled against purely documentary evidence in "Diskussionsbericht zu den Referaten Coing und Nielsen" (n 98) 162.

[141] BGH (n 134 *WM*) 2217; BGH (n 135 *WM*) 444; and OLG Bremen 1990 *WM* 1369 (1369-1370).

[142] BGH *BGHZ* 101, 84 91 ("pay first – litigate later").

[143] BGH (n 134 *BGHZ 90*) 292; OLG Düsseldorf 6 U 268/11 (04.10.2012) (juris) par 52, OLG Celle 2009 *WM* 1408 1410; OLG Saarbrücken 2001 *WM* 2055 2061; OLG Oldenburg 2001 *WM* 732 733; Graf von Westphalen and Zöchling-Jud (n 90) 200 par 195; Derleder, Knops and Bamberger (n 140) 1878 par 84; and Blesch and Lange (n 132) 165 par 558. See further for an instructive distinction between *formeller Garantiefall* and *materieller Garantiefall* the elaborations in Rüßmann "Die Auswirkungen des Grundsatzes der formellen Garantiestrenge auf die Geltenmachung einer befristeten Garantie auf erstes Anfordern" 1995 *WM* 1825 par I. The applicant can, under German law, apply for an urgent interim injunction, "einstweillige Verfügung", which would restrain the beneficiary from calling up the guarantee. See also chapter 3 par 3.4.2.6 above, and par 8.5 below.

Examples from case law may be used to illustrate the practical application of the doctrine of *Rechtsmissbrauch*. For instance, if the demand guarantee necessitates the happening of an event to trigger payment, for example the failure of performance stemming from the underlying contract, but such an obligation has become clearly impossible, and thus extinct, then any demand under the instrument would be perceived as an abuse of rights. This was decided in a case before the *Bundesgerichtshof*,[144] where the demand guarantee secured the vacating and return of real estate property which was made impossible by Iranian authorities, thus bringing the underlying obligation to an end. The claim on the guarantee, therefore, was rejected due to *Rechtsmissbrauch*. Another example is found in *Oberlandesgericht Oldenburg*,[145] where the court held that the event for payment under the guarantee had clearly not occurred ("somit 'liquide' bewiesen ist, daß der materielle Garantiefall nicht eingetreten ist") and, furthermore, that it was obviously impossible for the payment condition to materialise in the future ("bewiesen ist, daß der materielle Garantiefall […] auch nicht mehr eintreten kann"). Therefore, it was proven that the required event had certainly not happened, rendering any demand under the guarantee abusive. As was mentioned above, it is important to note that the threshold for invoking the *Rechtsmissbrauch* defence is reasonably high, and "regular" commercial disputes between the parties of the underlying contract have to be settled *after* payment of the instrument. A beneficiary of a letter of credit, for example, can be barred from demanding payment when shipping "entirely unsuitable goods" instead of the promised goods and thus committing a "very serious breach of contract".[146] On the other hand, shipping goods which are, possibly, only of inferior or questionable quality would not meet the *Rechtsmissbrauch* requirements, and challenges to the beneficiary's entitlement would have to be argued out at a later stage *after* payment.[147] The same is true in a demand-guarantee situation. In order to interfere with the independence principle by way of the *Rechtsmissbrauch* doctrine, the lack of material entitlement on the part of the beneficiary must be clear, obvious and beyond question – otherwise the independence principle would be eroded. The German approach of *Rechtsmissbrauch* is

[144] BGH (n 134 *BGHZ 90*) 291-292.

[145] (n 143) 734. Another interesting yet unusual example is provided in OLG Munich 7 U 313/12 (13.03.2013) (juris). See the case analysis in Kelly-Louw and Marxen (n 79) 295 *et seq*; and par 5.9 below.

[146] BGH 1955 *WM* 765 768 ("gänzlich ungeeignete Ware"; "sehr erhebliche Vertragsverletzungen"); and Ehrlich and Haas *Zahlung und Zahlungssicherung im Außenhandel* (2010) 270 par 2/418.

[147] See par 3.4.2.4 above.

further elaborated on, and compared, in the course of the thesis in the context of specific scenarios of potentially abusive conduct.

A clear distinction between the narrow and the wide concept of fraud is not regarded as necessary in German law. Also, the question as to *what* exactly qualifies as *fraud*, as is required and essential in South African and English law, does not arise in Germany. Instead, the German legal system operates with the concept of *Rechtsmissbrauch*; *fraud* is not utilised as the central issue.[148] Other potential abuses of a legal position acquired under the instrument, may justify exceptions to the principle of independence and, in some instance, may give rise to judicial intervention unrelated to any exception to independence. By dispensing with the focus on fraud the doctrine avoids concentrating on one legal key term (*fraud*) and engages with several different forms of abuse which can conceivably arise in a demand-guarantee transaction. Put differently, the doctrine of *Rechtsmissbrauch* allows for a more holistic approach. Seriously abusive behaviour other than fraud may be opposed with regard to, and subsumed under, the doctrine of *Rechtsmissbrauch*.

This, however, comes at a price: while potentially strengthening the notion of fairness, justice and equity, it is to the detriment of a fundamental cornerstone of commercial law – legal certainty.[149] As is evident from this thesis, the success and widespread application of demand guarantees in business transactions is owed to the security and liquidity functions fulfilled by these instruments, and the independence principle upon which these are based. Coupled with the need for (strict) documentary compliance,[150] all parties involved in the demand-guarantee transaction are able to foresee clearly the circumstances in which payment can be obtained. Acknowledging exceptions to the principle by way of the *Rechtsmissbrauch* defence, with its inherent flexibility, need for interpretation and far-reaching and extensive ambit, clearly runs counter to the security and liquidity functions of demand guarantees. On the other hand, as is evident from the doctrine's legal derivation from the good faith provision in paragraph 242 of the *BGB*, the *Rechtsmissbrauch* defence strongly supports considerations of fairness, equity and general good faith in commercial dealings. Against this background it is nevertheless of interest to note that a comparative review of the practical outcomes of cases

[148] Lohmann (n 125) 102 par 1.1.

[149] See par 3.4.2.4 and 3.4.2.7 above.

[150] Documentary compliance is discussed in detail in par 6.2 *et seq* below.

seeking to break through the independence principle often do not differ much, irrespective of the legal system involved.[151] As Bertrams explains,

> "much has been written on the concept of fraud, including the dogmatic aspects, [but] no clarity exists as to what precise kind of conduct on the part of the beneficiary and/or what specific facts relating to the underlying relationship, render a call fraudulent."[152]

In light of these observations, further situations in construction settings in which an abuse of demand guarantees could occur are assessed below with reference to the German doctrine of *Rechtsmissbrauch* in order to give more precise content to the defence.

5.2.10 The fraud exception: concluding remarks and analysis

In conclusion, it must be noted that fraud is a defence which remains at the centre of international scholarly discussions and judicial development, especially in English and South African law. The fraud exception in the narrow sense focuses very closely on the documents. While this approach shows respect for the "sanctity of the principle of independence of demand guarantees",[153] it does not allow for the sanctioning of other and different forms of fraudulent abuse. Especially for the commercial use of demand guarantees, this narrow interpretation of the fraud exception is probably not suited to deal with abusive conduct satisfactorily. Hence, English law has adopted the concept of "no honest belief", in terms of which a demand is deemed to be fraudulent not only in cases of presenting falsified

[151] Bertrams (n 7) 359 par 14-8 claims that in German case law "[t]he terms fraud and abuse are used interchangeably" (alteration and insertion by me). This statement could be used to explain the observation that the *practical outcome* of cases of potential abuse often does not differ remarkably, irrespective of the legal system called upon. With respect, however, it is submitted that German courts do not seem to use the terms "fraud" and "abuse" interchangeably in demand-guarantee case law, at least not within the last three decades. Further, generally note the concluding remarks in Horn and Wymeersch (n 1) 72-73; and "Diskussionsbericht zu den Referaten Coing und Nielsen" (n 98) 162, where it was concluded that comparative research is pointing to the fact that also foreign courts seem to appreciate the possibility of a defence based on abusive conduct ("[i]m übrigen zeige die Rechtsvergleichung, daß sich auch ausländische Gerichte der Sache nach dem Einwand des Rechtsmißbrauchs nicht verschließen" – alteration added and italics omitted by me). However, note the remarks to the contrary, or so it seems, in Coing (n 132) 144 par 9 (1) where it is argued that the notion of abuse of rights as a basis for interference in demand guarantees is far from being recognised internationally ("Der Gedanke der unzulässigen Rechtsausübung, wie wir ihn verstehen, ist keineswegs allgemein anerkannt. Man sollte ihn daher nicht im Zusamenhang mit einem internationalen Institut, wie der Bankgarantie, benutzen"). Lastly, see Zimmermann (n 132) 167 par b and 177 par d. Although not referring to demand guarantees in particular, her remarks (referring to equity as an exceptional remedy in English law and likening its principles to the notion of abuse of rights as a remedy in continental law) are noteworthy.

[152] (n 7) 358 (insertion by me, footnote omitted).

[153] Enonchong "The problem of abusive calls on demand guarantees" 2007 *LMCLQ* 83 85.

documents, but also if the beneficiary does not honestly belief in the validity of its statements or in the demand in general. Similar reasoning can be observed in some recent South African jurisprudence emphasising the beneficiary's "knowledge of lack of entitlement". However, the South African law in this regard has not yet been explained properly by the courts and fails to give sufficient guidance.

German law, on the other hand, resorts to the doctrine of *Rechtmissbrauch* as the primary tool to prevent abusive conduct. Conceptually, this is clearly a very different approach.[154] For the *Rechtsmissbrauch* exception to apply, a clear divergence between formal compliance with the guarantee as opposed to material, substantial entitlement must be evident when the beneficiary submits a demand. Thus, it is not the lack of an honest belief in the validity of the demand that is relevant, but rather the *Ausbleiben des materiellen Garantiefalls*, that is the *absence of material entitlement*. Usually, documentary proof of abusive conduct is required by the courts.

On closer analysis, however, it would appear that in many cases the application of English, South African and German law will probably lead to very much the same practical result.[155] For example, in the *Group Five* case[156] the South African court ruled that a beneficiary who called up a construction guarantee stating that the underlying contract had been "cancelled due to the contractor's default", as required in terms of the guarantee, was guilty of fraud if it knew that the underlying contract had in fact not been cancelled. Evidence was available in the form of numerous documents pertaining to internal communication of the beneficiary, a government agency, in which it was clear that the staff members of the agency knew that no cancellation had taken place. Applying the English formulation of "no honest belief" to the case, it is reasonable to assume that it would equally satisfy the test for fraud in English law. The beneficiary cannot have held an honest belief in the demand and its entitlement to the guaranteed sum given its positive knowledge of the absence of the cancellation, a prerequisite for the call on the guarantee. Practically speaking, the outcome in German law would be similar. Provided the documents can be seen as immediate and

[154] Lohmann (n 125) 102 par 1.1.

[155] As I have argued in Marxen "Abstrakte Garantie und Dokumentenakkreditiv in Südafrika" 2015 *Internationales Handelsrecht* (*IHR)* 137 146 par IV.

[156] *Group Five Construction (Pty) Limited v Member of the Executive Council for Public Transport Roads and Works Gauteng* (n 79).

compelling proof that the event triggering the guarantee, the cancellation of the construction contract, has clearly not happened, the doctrine of *Rechtsmissbrauch* would apply.[157]

Details and occasional differences in practical application, however, are best investigated and compared with reference to typical scenarios and construction settings in which the abuse and unjust practice occur; this is the approach taken in this thesis.

5.3 Final determination of the underlying dispute (final judgment, arbitration award and certification)

5.3.1 Introduction

The final determination of disputes originating from the underlying construction contract may have an impact on the question whether the demand guarantee can still be called up by the beneficiary. If legal disputes and factual uncertainties stemming from the relationship between the parties to the construction contract have been settled with finality, the security offered under the demand guarantee may conceivably be denied. In a construction setting, this issue typically arises either as a consequence of a final arbitration award[158] or the issuance of final certificates. The interesting and multifaceted issue of a final determination of the underlying dispute, and its potential impact on the validity of a call under a demand guarantee, is approached and discussed primarily from a South African perspective. Recent judicial development in South Africa justify the clear focus on this particular jurisdiction, as it provides a valuable insight and a sound basis for the consideration of conceptual and other crucial questions. This is followed by perspectives from English and German law and, finally, a critical comparative analysis.

5.3.2 Arbitration and the *Dormell* case

The first important instance of final determination of an underlying dispute and its potential legal effect on a call on a demand guarantee may be found in arbitration. Arbitration is a

[157] As is clear from, *inter alia*, OLG Oldenburg (n 143) 734 (although not dealing with a construction dispute).

[158] Or a final judgment; see par 5.3.4 below.

"private system of adjudication"[159] to determine commercial disputes. It is a popular method to settle disputes, especially in an international or transnational context.[160] It is based on an agreement between the parties to refer their present or future dispute to an arbitral tribunal,[161] which is called upon to decide it with finality.[162] The often reiterated advantages of arbitration (as opposed to litigation) are, among others, confidentiality, impartiality of the arbitrators, finality and the ease of international enforcement of the award, the expeditious manner in which a conflict can be resolved and the specific expertise of the arbitrators which can be selected directly by the parties.[163] Many (standard-form) construction contracts contain an arbitration clause;[164] hence many construction disputes are resolved by arbitrators. The finality of the arbitration award is central to the present discussion.[165] Subject to limited exceptions, the award rendered by an arbitral tribunal is binding, final and enforceable by the

[159] Moses *The Principles and Practice of International Commercial Arbitration* (2012) 1.

[160] Born *International Commercial Arbitration Volume I* (2014) 93-97; Greenberg, Kee and Weeramantry *International Commercial Arbitration* (2011) 1 par 1.1; McKendrick (n 49) 1300 par 2; and Nisja "The engineer in international construction: agent? Mediator? Adjudicator?" 2004 *The International Construction Law Review* 230 231 par 1.2.

[161] Bailey *Construction Law Volume III* (2011) 1632-1633; Greenberg, Kee and Weeramantry (n 160) 21 par 3.4.1; McKendrick (n 49) 1309 *et seq*; and Moses (n 159) 2 par 1.

[162] Born (n 160) 83 par 5; Moses (n 159) 2-3 par 3; Bunni *The FIDIC Forms of Contract* (2005) 388 par (i); Greenberg, Kee and Weeramantry (n 159) 23 par 1.83; as well as Bailey (n 161) 1699 par 25.162.

[163] Berger *Private Dispute Resolution in International Business Volume II* (2015) 284 par 16-6; Leisinger *Vertraulichkeit in internationalen Schiedsverfahren* (2012) 33 *et seq*; Chow and Schoenbaum *International Business Transactions* (2015) 592; Born *International Arbitration: Law and Practice* (2012) 9 par 1.02 *et seq*; McKendrick (n 49) 1321; Bailey (n 161) 1645-1646 par 25.52; Hughes, Champion and Murdoch *Construction Contracts Law and Management* (2015) 410-411 par 24.4.1; Nagel *Business Law* (2015) 274 par 17.19; Schütze *Schiedsgericht und Schiedsverfahren* (2012) 13-15; and Bunni (n 162) 388-389. The international recognition and enforceability of arbitral awards is based on the successful ratification of the "Convention on the Recognition and Enforcement of Foreign Arbitral Awards", known as the "New York Convention (1958)". One must also note, however, the potential shortcomings and disadvantages of commercial arbitration as a private dispute resolution method. See, for example, Berger "Schiedsgerichtsbarkeit im Bank- und Kapitalmarktrecht" in Habersack, Joeres and Krämer *Entwicklungslinien im Bank- und Kapitalmarktrecht Festschrift für Gerd Nobbe* (2009) 473 478 *et seq*. A full discussion of these issues, however, falls outside the scope of this thesis.

[164] See for example GCC 2010 clause 10.7; JBCC 2014 (Principal Building Agreement PBA) clause 30.7; JCT 2011 (Standard Form of Building Contract) clause 8; Weselik and Hamerl *Handbuch des internationalen Bauvertrags* (2015) 24 par a; and Ramsden *McKenzie's Law of Building and Engineering Contracts and Arbitration* (2014) 231 par 20.1 and 233 par 20.3.

[165] Therefore other methods of alternative dispute resolution, for instance mediation, adjudication or ICC DOCDEX dispute resolution (under the ICC Rules for Documentary Instruments Dispute Resolution Expertise (DOCDEX)) do not fall within the scope if the outcome of the process lacks finality and binding force upon the parties. See Song "Sectoral dispute resolution in international banking (documentary credit dispute expertise: DOCDEX)" 2013-2014 *Arizona Journal of International and Comparative Law* 529 533 and 555. For adjudication and construction disputes, see par 8.2 and 8.3 below.

successful party.[166] In considering the potential impact of such an award on the beneficiary's right to call up the guarantee a good point of departure is the South African case *Dormell Properties 282 CC v Renasa Insurance Co Ltd*,[167] which attracted considerable attention soon after the judgment was handed down.

The facts, somewhat simplified, can be summarised thus: in order to develop and construct a shopping centre, Dormell[168] as employer engaged Synthesis[169] as contractor to execute certain works. To secure its obligation under the construction contract, Synthesis applied to Renasa[170] for the issuance of a performance guarantee, payable on demand. Renasa issued such a guarantee in favour of Dormell.[171] After the project underwent delays and the expected date of completion had to be postponed, Dormell and Synthesis entered into a dispute concerning the extension of the guarantee so as to cover the amended period of construction.[172]

Dormell eventually gave notice of cancellation of the construction contract to Synthesis, and called up the guarantee. Because Renasa rejected the demand for payment under the guarantee, Dormell approached the South Gauteng High Court for an order compelling Renasa to pay. The court dismissed the claims on grounds that were bad in law and require no further comment here.[173] Leave to appeal to the Supreme Court of Appeal was granted.[174] Prior to the hearing of the appeal, Dormell and Synthesis submitted their dispute, especially

[166] See the in-depth discussion in Born (n 163) 303 *et seq* and 383 *et seq*; Moses (n 159) 203 *et seq*; and Tang *Jurisdiction and Arbitration Agreements in International Commercial Law* (2014) 224 *et seq* as well as 249 par 4.4 *et seq*. For purposes of this thesis a further analysis of this issue is not warranted.

[167] 2011 (1) SA 70 (SCA). This case is mainly referred to as *Dormell Properties* below.

[168] The proper name being Dormell Properties 282 CC, a fact which played a part in the preceding litigation before the South Gauteng High Court (Gildenhuys J) and the appeal to the SCA. Dormell was identified as Dormell Properties 282 (Pty) Ltd in the guarantee documents under dispute, which led to an application for rectification. On this aspect of the judgment see par 6.3.4.1 below.

[169] Synthesis Projects (Cape) (Pty) Ltd. The contractor Synthesis went into liquidation and was subsequently represented by its liquidators in the court proceedings.

[170] Renasa Insurance Co Ltd.

[171] For purposes of this thesis the facts are simplified and it is accepted that Renasa issued only one demand guarantee, and exactly as requested, so that the problem of reissuing and replacing of guarantees can be disregarded (see par 9-10 of the judgment).

[172] par 12-14.

[173] This related to rectification and expiry of the guarantee. See par 16-18 of the judgment, as well as Kelly-Louw (n 58 *2014*) 205; and Hugo "Documentary credits and independent guarantees" 2011 *Annual Banking Law Update* 116 124-125.

[174] par 18.

the validity of Dormell's cancellation of the construction contract, to an arbitral tribunal.[175] The tribunal found in favour of Synthesis, confirmed that the contractor was not in breach of contract, and held that Dormell's cancellation was unlawful and thus invalid.[176] The relevant question before the Supreme Court of Appeal related to the effect of the arbitration award, in favour of Synthesis, on Dormell's rights under the guarantee.[177]

Both Renasa and Synthesis argued that the call on the demand guarantee was unjustified and therefore had to be denied. They based their argument primarily on the award rendered by the arbitrators. Bertelsmann AJA, writing for the majority,[178] explained:

> "[T] they rely on the arbitration award for the submission that the guarantee is no longer enforceable as a competent tribunal has found that the employer was in breach of the building contract and Synthesis was entitled to cancel the same. Dormell is therefore no longer bona fide when it insists on payment of the guarantee. Any entitlement to call for payment has fallen away, they submit."[179]

After introducing the respondents' pleas, he went on to set out the nature of the guarantee in question, and confirmed its independence from the underlying contract. Citing Navsa JA in *Lombard Insurance Company Ltd v Landmark Holding (Pty) Ltd*,[180] and Scott AJA in *Loomcraft Fabrics CC v Nedbank Ltd*,[181] he concluded:

> "In principle therefore, the guarantee must be honoured as soon as the employer makes a proper claim against it upon the happening of a specified event. In the present case there is no suggestion that Dormell did not properly demand payment of the guaranteed sum. In the normal course of events payment should have been effected within seven days of demand."[182]

However, he then turned to the attempt by Renasa and Synthesis to adduce evidence of the arbitral award to substantiate the claim that Dormell was "no longer bona fide when it insists on payment of the guarantee",[183] and held:

> "[T]he facts of this matter are unusual because the arbitration of the dispute between Dormell and Synthesis resulted in the finding that the appellant was not entitled to cancel the building contract. The

[175] par 19.

[176] par 20.

[177] The issues concerning the alleged expiry of the demand guarantee and the rectification of the named parties in the guarantee are not relevant for this discussion.

[178] His judgment was concurred to by Cachalia and Mhlantla JJA, par 47. The minority judgment by Cloete JA was supported by Mpati P in its entirety, and in part by Cachalia and Mhlantla JJA (regarding par 48-59, as explained in par 70).

[179] par 25 (alteration by me).

[180] n 120.

[181] n 59.

[182] par 39.

[183] par 25.

> arbitration is final, not subject to appeal and has not been taken on review. A second leg of the arbitration dealing with outstanding claims arising from the building contract was also decided in Synthesis' favour. The question must thus be answered whether Dormell is entitled to persist in claiming payment of the guarantee notwithstanding the fact that it has been held to have repudiated the contract which was lawfully cancelled by the second respondent."[184]

Further on in his judgment he continued as follows:

> "There is no longer any dispute about the cancellation of the underlying agreement that still has to be resolved. The arbitration has established that Dormell is in the wrong. Its repudiation of the building contract was held to have been unlawful. As a consequence, Dormell has lost the right to enforce the guarantee. There remains no legitimate purpose to which the guaranteed sum could be applied."[185]

Thus fortified, he moved on to consider the hypothetical consequences, should the court allow the demand for payment of the guarantee:

> "If [Renasa] were to be ordered to honour the guarantee, Renasa or Synthesis would be entitled to repayment of the full amount guaranteed."[186]

> "It would amount to an academic exercise without practical effect if Dormell were to be granted the order it seeks […] Such an order would, at best, cause additional cost and inconvenience to the parties, without any practical effect […] [T]he court must exercise its discretion against Dormell […]."[187]

Thus, in the opinion of the majority, the outcome of the arbitration had to be recognised in the litigation process. Because it denied any monetary entitlement of Dormell against Synthesis, it barred any calls on the guarantee against Renasa. Accordingly, Bertelsmann AJA, with Cachalia JA and Mhlantla JA concurring, dismissed the appeal and denied Dormell's claim under the guarantee.[188]

The minority judgment written by Cloete JA (with Mpati P concurring), disagreed with the majority on the relevance of the outcome of the arbitration as expressed by Bertelsmann AJA. In this regard,[189] Cloete JA emphasised the separate relationships between the involved parties:

> "It is important to bear in mind that in cases such as the present there are three separate legal relationships:

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[184] par 40.

[185] par 41.

[186] par 42 (alteration by me).

[187] par 45 (insertion and omission by me).

[188] par 47. Note, however, that the original orders by the preceding High Court were set aside, so that the appeal failed solely on the newly introduced evidence concerning the arbitration award in Synthesis' favour. Regard may be had to s21(A) of the Supreme Court Act 59 of 1959, which allows the court to dismiss an appeal on the grounds that the judgment or order sought would have no practical effect; see par 45.

[189] Cloete JA dealt also with the issue of rectification and expiry of the guarantee (par 51-59), which are not relevant here.

(a) one between the employer and the contractor, usually termed a building contract, pursuant to which the contractor undertakes to perform building works for the employer;

(b) one between the employer and a financial institution which the employer requires the contractor to procure to protect the employer against possible default by the contractor under the building contract, which is variously called a performance guarantee, a performance bond or a construction guarantee, and in terms of which the financial institution undertakes to the employer that it will make payment to the employer on the happening of a specific event; and

(c) one between the contractor and the financial institution for the provision by the latter of a guarantee to the employer.

The construction guarantee which [Dormell] seeks to enforce in the present appeal is an example of the second type of contract."[190]

Having elaborated on the need for clear separation of the different relationships, Cloete JA continued to examine the demand on the guarantee:

"The appellant complied with the provisions of clause 5 [the relevant clause in the guarantee]. 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."[191]

He then engaged directly with the reasons given by Bertelsmann AJA, stated as follows:

"My learned colleague reasons that a valid demand on the construction guarantee is subject to a bona fide claim that an event has occurred that is envisaged in the guarantee as triggering the guarantor's obligation to pay. Put more accurately, a valid demand on the construction guarantee can only be defeated by proof of fraud. In the present matter there was a valid demand. There was no suggestion of fraud. Once the appellant had complied with clause 5 of the guarantee, the first respondent had no defence to a claim under the guarantee. It still has no defence."[192]

As regards the relevance of the arbitration award, Cloete JA argued:

"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. It is *res inter alios acta* so far as the first respondent is concerned. […] [T]he 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 guarantee given to it by the first respondent. Nor does it have to do so now."[193]

Furthermore, he analysed the sequence of events and expressed his opinion on the effect the arbitral award should have on the call on the guarantee. Additionally, he addressed the issue of finality of the award:

"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,

[190] par 61 (alteration by me).

[191] par 63 (insertion by me).

[192] par 63-64.

[193] par 64.

> 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 been 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."[194]

In his opinion, the claim under the guarantee was accordingly not restricted or barred by way of the subsequent arbitration proceedings; Dormell should have been successful with its demand. For these reasons, Cloete JA eventually concluded that the appeal by Dormell ought to have been allowed.[195]

The majority judgment by the SCA in *Dormell Properties* clearly paved the way for further inroads into the principle of independence in South African law. Apart from fraud by the beneficiary, the final determination of the underlying dispute by way of arbitration could defeat the autonomous nature of demand guarantees. Hugo welcomed the judgment at that time and described it as "a beneficial development of our law".[196] Although there is no information as to the direct impact of *Dormell Properties* on the construction industry in South Africa, one can assume that it had considerable influence. This is borne out in the following remarks of Navsa ADP and Pillay JA in the case of *Coface South Africa Insurance Co Ltd v East London Own Haven*:[197]

> "Since the decision in *Dormell* and perhaps predictably, there has been an increasing number of cases in which guaranteeing banks have sought to introduce contractual disputes in order to avoid meeting the guarantee. In some cases the allegedly defaulting contractor sought to join the fray. It is the very consequence that the line of cases prior to *Dormell* sought to avoid."[198]

Although the majority judgment in *Dormell Properties* did not reflect the South African law for long,[199] a thorough analysis of the decision is beneficial for a proper understanding of subsequent developments in South Africa, and for the purpose of legal comparison.

The *Dormell Properties* case connects demand guarantees and arbitration agreements. The majority decision appreciated the merits of the arbitral award which settled the

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[194] par 65.

[195] par 70.

[196] Hugo (n 173) 126. However, in light of subsequent case law he reconsidered and changed his views. See Hugo "Protecting the lifeblood of commerce: a critical assessment of recent judgments of the South African supreme court of appeal relating to demand guarantees" 2014 *TSAR* 661 666 (n 35).

[197] n 105.

[198] par 24.

[199] The repeal of the *Dormell Properties* decision (n 167) in December 2013 is dealt with extensively in par 5.3.3 below.

underlying dispute, and therefore allowed the introduction of these findings into the guarantee dispute. The decision effectively accepted that the final determination of the underlying dispute can defeat the autonomous obligation under a demand guarantee. A proper analysis of the judgment, it is submitted, requires consideration of the following crucial issues: (i) the *finality* of the award, (ii) the *sequence of events*; and (iii) the *legal approach* by which the final dispute resolution is engaged in demand guarantees.

As regards the importance and legal relevance of the *finality of the award*, Bertelsmann AJA remarked: "There is no longer any dispute about the cancellation of the underlying agreement that still has to be resolved. The arbitration has established that Dormell is in the wrong."[200] In so far, one can only agree. If the parties' intentions (in the original construction contract) to arbitrate are taken seriously, then the arbitral award must be accepted. If the parties agreed on an arbitration clause in the construction contract, there is an implied promise to respect findings stemming from the arbitration proceeding, and not to undermine such by claiming under the guarantee if such claim would violate the award. This can also be extended to other instances of final determination by agreement, for example a private settlement compromise or the determination of a dispute or claim by certification.[201] The means of final determination cannot be limited to arbitration, but must include further instances derived from party autonomy. A final court judgment, albeit practically unlikely due to the typical duration of litigation proceedings,[202] would have to have the same effect.

It must be emphasised that the finality of the arbitral award is central. Dispute resolution through adjudication, for example, is not comparable because of its provisional and non-binding character.[203] Because of its finality, which assumes the absence of any legal remedy to rectify or appeal (or the inactivity by the party adversely affected), the *correctness* of the award is *irrelevant*. Therefore, it is respectfully submitted, that the reasoning of Cloete JA "that the fact that the arbitrator's award is final […] does not mean that it is correct" cannot add any weight to his otherwise well-reasoned minority opinion. Were this particular point valid, it would seriously undermine the concept of legal force, *res judicata* and finality

[200] par 41.

[201] This aspect is dealt with in par 5.3.3 below.

[202] See Lücke *Das Dokumentenakkreditiv in Deutschland, Frankreich und der Schweiz* (1976) 176.

[203] *Radon Projects (Pty) Ltd v N V Properties (Pty) Ltd* 2013 (6) SA 345 (SCA); Coulson *Coulson on Construction Adjudication* (2015) 60 par 2.112, 131 par 4.107 and 405 par 14.33; and Uff *Construction Law* (2013) 67.

through the backdoor of an implied re-evaluation or disguised *quasi-appeal*. Finality, in the present context, means that the decision reflects the factual and legal situation in a comprehensive and final manner. The parties cannot deny, dispute or counter any findings made by the arbitrators– their decision settled the dispute conclusively and finally.

Apart from the finality of the award, the *sequence of events* in the commercial transaction has to be considered. In *Dormell Properties*, the arbitration proceedings took place well *after* the call on the demand guarantee by Dormell. It was common cause that at the time of the proceedings before the court of first instance, there was no final arbitral award.[204] On this point, the majority and minority judgments part ways. While the majority highlighted the resolution of the underlying dispute ("There is no longer any dispute […] that still has to be resolved"),[205] the minority stressed the order in which the demand and the arbitration occurred:

> "[I]t is not bad faith […] 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 […] to have been unjustified."[206]

This approach by Cloete JA has merit, and is firmly supported by considerations of legal certainty. The relevant point in time to examine a demand under an independent guarantee is at the time of the demand itself. Later developments, subsequent to the demand, should be disregarded. If one were to allow events following the presentation of the demand potentially to affect an initially valid, complying and justified demand, the beneficiary can never be sure whether its demand will be accommodated by the guarantor. Moreover, allowing subsequent events to have a legal bearing on the initial demand could lead to guarantors (or applicants) delaying payment unreasonably in certain circumstances in the hope that payment could be avoided once further facts are established. Such uncertainty would be damaging a core objective of demand guarantees, namely the creation of an assured right of payment in clearly defined circumstances.

From the perspective of the sequence of events it follows that Dormell's claim on the demand guarantee should have been allowed. The final accounting for monies paid out under

[204] See par 23.

[205] par 41 (per Bertelsmann AJA – omission and insertion by me).

[206] par 65 (per Cloete JA – omissions, insertions and emphasis by me).

the guarantee,[207] and the substantive entitlement to such money should properly have been considered only after the guarantee sum had been released to Dormell.

The significance of the exact order of events leads to another important issue which concerns the *conceptual approach* with which the *Dormell Properties* situation should ideally be examined. Both Kelly-Louw[208] and Hugo[209] interpreted the majority decision as having recognised, apart from fraud, another exception to the independence principle. There are, however, two further possible conceptual approaches towards the Dormell Properties situation. The first relates to negative underlying stipulations restricting the calling-up of the guarantee, and the second to the fraud exception.

The first approach would regard the final determination issue as belonging to the wider *negative stipulation defence*. The final determination of an underlying construction dispute through arbitration can naturally be linked to the original construction agreement, and the arbitration clause contained therein. Now, if the construction contract were to provide for arbitration in the case of a dispute between the parties, one can conceivably read into the agreement the implied promise to respect and give effect to the award.[210] This would compel the parties to the arbitration agreement, the employer and contractor, to refrain from undermining the arbitration agreement in certain circumstances by demanding payment on the guarantee after the arbitration award has been handed down. This approach would give substantive effect to the parties' intention that their dispute should be finaly resolved by arbitration.

[207] In regard to final accounting, see generally Enonchong (n 15) 271 *et seq*; Beale *Chitty on Contracts Volume II Specific Contracts* (2012) 778 par 37-131; Davis (n 105) 10-11 par 2.42-2.47; Davis *Construction Insolvency* (2014) 815 par 19-044 *et seq*; and Panagiotopoulos (n 132) in its entirety. Furthermore, the JBCC Construction Guarantee stipulates in clause 7.0: "Where the Guarantor is a registered insurer and has made payment in terms of 5.0, the Employer shall within one hundred and eighty (180) calendar days of receipt of payment submit an expense account to the Guarantor showing how all monies received in terms of the Guarantee for Construction have been expended, or will be expended, and shall refund to the Guarantor any surplus amount". Similary, clause 5.0 of the JBCC Payment Guarantee reads: "Where the Guarantor is a registered insurer and has made payment in terms of 3.0, the Contractor shall upon the date of issue of the final payment certificate submit an expense account to the Guarantor showing how all monies received in terms of the Payment Guarantee have been expended and shall refund to the Guarantor any resulting surplus".

[208] Kelly-Louw (n 58 *2014*) 200.

[209] Hugo (n 173) 126; see also Hugo (n 83) 172 (albeit probably more cautiously).

[210] Regarding the issue of implied promises and restricting agreements in the underlying construction contract, see chapter 7 below.

A further consequence of this conceptual approach would be that only the applicant may invoke the negative stipulation as an argument to resist a demand for payment.[211] Only the parties to the arbitration[212] are bound by the award,[213] a point clearly recognised by Cloete JA in his minority judgment in which he stated:

> "The fact that an arbitrator has determined that the appellant [Dormell] was not entitled to cancel the contract, binds the appellant [Dormell] ─ but only vis-à-vis the second respondent [Synthesis]. It is *res inter alios acta* so far as the first respondent [Renasa] is concerned."[214]

This conceptual approach would accordingly provide no basis upon which the guarantor could attempt to resist payment under the guarantee.[215] It would further entail that the principle of independence would not be infringed upon. Put differently, in accordance with this approach the underlying contract, the arbitration clause and the implied promise to honour the arbitral award would simply be enforced as between the parties to the contract (the employer and contractor).

A second possible approach to the calling up of a guarantee when the underlying dispute has been finally determined against the beneficiary is to regard it as a *fraudulent demand*. This approach obviates the necessity of recognising another exception to the independence principle.[216] The order of events can point to positive knowledge on the part of the beneficiary regarding its lack of entitlement to the monies demanded under the guarantee. Should the final determination of the underlying dispute (the beneficiary's potential disentitlement) have occurred *before* the demand under the guarantee, it can be argued that the beneficiary is demanding payment while knowing it is not entitled thereto. Bertrams subscribes to this argument as follows:

> "If a court or arbitrator, in main proceedings, pronounces the dissolution or the avoidance of the secured contract without any liability on the part of the applicant or if the beneficiary's claim against

[211] See chapter 7 below, especially par 7.4 and 7.5.

[212] Involvement is achieved by being a contractual party (signatory) to the original arbitration agreement, or through a procedural joinder of a third-party. See for example Moses (n 159) 34 *et seq*. A detailed analysis of third-party involvement in arbitration and joinder, however, is beyond the scope of this thesis.

[213] See in this regard the interesting case review by Weise "Wirkt die Schiedsvereinbarung gegen den Bürgen?" 2015 *NJW-Spezial (Heft 4)* 108. Although the article is concerned with judgments involving suretyship and accessory guarantees ("Bürgschaften"), it explores a legal notion which is equally valuable for this thesis and the present discussions of independent demand guarantees.

[214] par 64 (insertions by me).

[215] Although not expressly so stated, it would appear for this reason that Kelly-Louw (n 58 *2014*) 216 and 218 accepts this conceptual approach.

[216] Hugo (n 196 *TSAR*) 666 and 673-674; and Hugo "Documentary credits and independent guarantees" 2014 *Annual Banking Law Update* 49 51-52.

> the applicant has been dismissed on the merits of the case, a subsequent call on the guarantee is evidently fraudulent."[217]

In order to raise the fraud exception to a demand under a guarantee in these circumstances, fraud must be viewed as comprising the absence of an "honest belief" in the validity of the demand, or positive "knowledge of the lack of entitlement", as opposed to the mere forgery of documents.[218] Theron JA's judgment in *Guardrisk v Kentz*,[219] it is argued, supports such an argument in South African law. She held:

> "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."[220]

Accordingly, it can be argued that in a particular case the final determination of the dispute in the underlying transaction may be relevant evidence to establish the fraud exception. As stated by Hugo:

> "Such [final determination], especially if known to the beneficiary prior to the demand, can be indicative of the absence of an honest belief on the part of the beneficiary that it is entitled to demand payment under the guarantee. As such it can open the door to the fraud exception."[221]

Applying the fraud exception would entail certain benefits.[222] It removes the need to advocate for a further exception to the principle of independence – something which almost invariably leads to strong resistance in the banking community. Instead, the final-determination argument is simply integrated into the accepted and well-established fraud exception. Furthermore, it is submitted that this approach captures appropriately the beneficiary's conduct for what it is – fraudulent behaviour.

Applied to the *Dormell Properties* case, however, it is clear that this line of reasoning could not have been invoked successfully against Dormell's demand since the final determination of the underlying dispute occurred well *after* the demand was submitted. Hence there is no room to argue that Dormell had positive knowledge of its disentitlement at the time of the demand.

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[217] (n 7) 409 par 14-50.

[218] See the extensive discussion in par 5.2 *et seq* above.

[219] n 73.

[220] par 17.

[221] (n 196 *TSAR*) 666 (alteration and omission of his footnote by me).

[222] Marxen (n 155) 143-144.

The *Dormell Properties* case, however, reflected the law in South Africa only for a short while. After the judgment was handed down in October 2010, it soon became clear from *dicta* of other judges in the SCA that they disagreed with the reasoning in *Dormell Properties*.[223] The process of certification, and its potential legal implications for demand-guarantee transactions, gave the Supreme Court of Appeal further opportunities to pronounce on this aspect of the law relating to demand guarantees.

5.3.3 Certification in the construction industry and the *Brera* and *Coface* cases

Certification plays an important role in any major engineering or construction project. Kelley[224] explains:

> "Large construction projects can last for several years and even relatively small projects can last for several months. Because few contractors or suppliers are able to wait until final completion to receive payment for their work, regular progress payments are necessary."

Therefore, the parties engaged in construction need a mechanism to determine the amounts payable and due during the construction process before completion. Certification has evolved from this background.[225] To cite Bailey, a certificate is a "statement (usually written) by a contract administrator, or other person, which have [sic] contractual effect as an assessment or statement of facts, or rights and obligations."[226] Construction and design professionals such as architects and engineers are usually called upon to issue these certificates.[227] Certificates can point to many different facts and details, for instance the progress or completion of certain sections, construction phases or the project as a whole (final completion), the supply of material and quantity and quality thereof, the extent of damages sustained due to construction faults or poor workmanship, the sums due to contractors for services rendered, and so forth.[228] The legal and practical effect of a certificate being issued

[223] Note, among others, the remarks in *Coface South Africa Insurance Co Ltd v East London Own Haven t/a Own Haven Housing Association* (n 105) par 24 (per Navsa ADP and Pillay JA). For a detailed discussion of *Coface v East London Own Haven* see par 5.3.3 immediately below.

[224] *Construction Law* (2013) 147.

[225] Nienaber "Construction contracts" in Harms *The Law of South Africa Volume 9* (2015) 1 32 par 69; Coulson (n 203) 283 par 9.06; and Uff (n 203) 269.

[226] Bailey *Construction Law Volume I* (2011) 335 par 5.98 (n 272) (insertion by me).

[227] See par 2.2 above.

[228] For instance *Maykent v Trackstar* [2015] ZASCA 14 (17 March 2015) par 3 *et seq*; Ramsden (n 164) 204 *et seq*; Uff (n 203) 287; Kelley (n 224) 117 *et seq*; Bailey (n 226) 335-336 par 5.99; Kelleher, Mastin and

depends on the provisions in the construction contract between the employer and the contractor,[229] but it seems that commonly they are regarded as conclusive evidence if they are so-called final certificates (as opposed to mere interim certificates).[230] The legal implications of such final certificates are explored by the Supreme Court of Appeal in the cases *First Rand Bank v Brera*, *Guardrisk v Kentz* and *Coface v East London Own Haven* which are dealt with immediately below.

In *First Rand Bank v Brera*,[231] the Supreme Court of Appeal was called upon to decide a case involving a demand guarantee, interim payment certificates and a sub-contractor.[232] The contractor, Spirit of Africa, engaged Brera Investments as sub-contractor for electrical installation works in a windmill park. Security for payment owed by Spirit of Africa to sub-contractor Brera Investments was provided for by way of a payment guarantee, issued by First Rand Bank. This demand guarantee stipulated for liability of the guarantor (First Rand Bank) under two circumstances: (i) if the beneficiary (Brera Investments) submitted a written demand and a statement alleging that certified sums had not been paid by the contractor within seven days, or (ii) that the contractor (Spirit of Africa) failed to have such a payment certificate issued within seven days after demand for it had been made.[233] When the contractor failed to have a certificate issued for the sum of about one million Rand as requested, the beneficiary (sub-contractor Brera Investment) called up the guarantee.[234] The guarantor failed to comply with the demand, and the beneficiary instituted legal action before the High Court. The contractor subsequently issued a certificate, but only for the sum of approximately R60 000. The certificate stated that "the other amounts claimed were disputed and were not certified".[235] The guarantor sought to rely on the fact that a certificate was

Robey *Smith, Currie and Hancock's Common Sense Construction Law* (2015) 219-220; and Hughes, Champion and Murdoch (n 163) 294-295 par 18.2.1.

[229] Uff (n 203) 284; Bailey (n 226) 340 par 5.111; and Hughes, Champion and Murdoch (n 163) 297-299. For provisions relating to certification in standard-form construction contracts see the JBCC 2014 (Principal Building Agreement PBA) clauses 19.3.3, 20.2.1, 20.2.2, 21.8, 25.2, 25.13, and 27.1; and the GCC 2010 clauses 5.14.2, 5.14.4, 5.16.1, 6.10.1, 6.10.8, 6.10.9, and 9.1.5.3.

[230] Beale (n 207) 831-832 par 37-252; Hughes, Champion and Murdoch (n 163) 297-299; Nienaber (n 225) 34 par 74; Ramsden (n 164) 208-211; Bailey (n 226) 351 par 5.134 *et seq*; and Uff (n 203) 286 and 289.

[231] n 120.

[232] Certain facts have been simplified for purposes of this thesis, so that emphasis can be placed on the pivotal issues most relevant for the current discussion.

[233] See par 5-6.

[234] par 7.

[235] par 7.

eventually issued, and, therefore, the liability of the bank had either fallen away in its entirety, or that the guarantor was only liable to the extent set forth in the certificate.[236] As may have been expected, the guarantor relied on *Dormell Properties* to introduce evidence of events which happened subsequent to the demand.[237]

The court of first instance rejected this approach with reference to the unambiguous terms of the guarantee.[238] On appeal the Surpeme Court of Appeal held that at the time of the demand the conditions captured in the guarantee were satisfied; hence any event after the demand (the issuance of the certificate and the certification of a lesser sum than the demanded amount) was irrelevant.[239] Furthermore, the court drew attention to the fact that the certificate under consideration was not agreed between the parties to be a *final* certificate, but only an *interim* certificate.[240] For this reason, Malan JA was able to distinguish the case from *Dormell Properties*: "The facts of this matter are distinguishable and concern an interim payment under an interim payment certificate. There was no final arbitration award as in Dormell."[241] Accordingly, the appeal by the guarantor was dismissed.[242]

Despite having distinguished the *Dormell Properties* case, Malan JA went on to write "[i]n any event, I consider that the better approach in that case is that of Cloete JA",[243] thereby expressing his preference for the minority judgment in *Dormell Properties* delivered by Cloete JA. Although only an *obiter dictum* with "persuasive value" at the time,[244] this remark heralded the Supreme Court of Appeal's imminent departure from the majority decision in *Dormell Properties*.

The Supreme Court of Appeal's incremental rejection of *Dormell Properties* continued with *Guardrisk v Kentz*.[245] Without presenting the facts of this case,[246] it is noteworthy that

[236] par 9.

[237] See par 10.

[238] as was pointed out by Malan JA in par 8.

[239] par 8 *et seq*.

[240] par 10.

[241] par 10.

[242] par 12.

[243] par 10 (alteration by me).

[244] Kelly-Louw (n 58 *2014*) 200 and 211.

[245] n 73.

Theron JA (with Navsa ADP, Shongwe, Saldulker JJA and Meyer AJA concurring) voiced strong support for the views of Malan JA referred to above:

> "This court in [*First Rand Bank v Brera*] stated that the better approach is that of the minority in [*Dormell Properties*]. I agree. Malan JA, writing for the court in [*First Rand Bank v Brera*], supported the reasoning of Cloete JA […]."[247]

She continued in unmistakeable terms and concluded: "The reasoning of the majority in [*Dormell Properties*] is flawed."[248] This clearly constituted another strong attack on the majority judgment in *Dormell Properties*.

The judicial "onslaught" on *Dormell Properties* continued, so that it was eventually "laid to rest"[249] in *Coface v East London Own Haven*.[250] In this appeal, the Supreme Court of Appeal had to concern itself once more with certificates and their legal implications for a call on a demand guarantees in a construction setting. The relationships in this case, appropriately simplified, were as follows: East London Own Haven (ELOH) concluded a construction contract with a building contractor. The contract required the contractor to apply to Coface, an insurance company, for the issuance of a demand guarantee securing its proper performance. At the behest of the contractor, Coface duly furnished the construction guarantee to ELOH. The guarantee provided for payment in the event of the construction contract being cancelled due to the contractor's default.[251] Because of unsatisfactory performance ELOH cancelled the contract and called up the guarantee in a formally compliant manner, that is enclosed a copy of the cancellation notice and stated that cancellation occurred due to the contractor's default. The guarantor Coface, however, denied liability on the guarantee and alleged that ELOH had not been entitled to cancel the contract as it was in fact ELOH who was responsible for work delays due to faulty design.[252] ELOH

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[246] For a concise case discussion see Hugo (n 216 *2014*) 51 (n 12); as well as Kelly-Louw (n 58 *2014*) 203 and 211-212.

[247] par 25 (insertions, omissions and alterations by me).

[248] par 26 (insertion and alteration by me).

[249] Both quotes taken from Hugo (n 216 *2014*) 49. Van Niekerk and Schulze (n 21) 285 write of "the final nail in the coffin of the majority judgment in *Dormell Properties*".

[250] *Coface South Africa Insurance Co Ltd v East London Own Haven t/a Own Haven Housing Association* (n 105).

[251] See par 2.

[252] par 4.

excepted to this argument, and the case was heard before the High Court.[253] Relying on *Dormell Properties*, the High Court dismissed the exception and ruled in favour of Coface:

> "In the present case, the fact is that there is only one ground permitted for cancellation which would render the insurer liable. That ground is the statement that cancellation is due to the contractors [sic] default. All that is required is a statement. But, as has been exemplified in [*Dormell Properties*], that statement can be successfully challenged and the employer may be denied its claim to the guaranteed sum."[254]

When the case was subsequently heard on the merits,[255] Lamont J was confronted by an application of Coface to amend its plea. The guarantor now sought to introduce payment certificates and a recovery statement which had been issued in the meantime.[256] A recovery statement is a formal listing which "sets out the penalties, default interest, losses and the like owing by the one party to the other"[257] and therefore finalises the determination of the amounts due to one of the parties.[258]

Coface's case in this regard was summarised as follows when the matter eventually came before the Surpeme Court of Appeal:

> "1) The final amount payable by the contractor to the ELOH was finally determined by the issue of a final payment certificate (incorrectly labelled interim payment certificate) which certificate purported to set out an amount constituting the recovery of an overpayment by the plaintiff to the contractor which was due by the contractor to the plaintiff.
>
> 2) That a recovery statement had been issued simultaneously with that certificate reflecting an amount of R nil recoverable by the ELOH from the contractor as damages.
>
> 3) That the issue of the certificate finally determined that the contractor did not owe any amount to the ELOH as a result of the alleged breach of contract by the contractor.
>
> 4) In the premises Coface was not obliged to make the payment in terms of the guarantee as the indebtedness due to the ELOH by the contractor did not fall within its terms."[259]

The Supreme Court of Appeal further explained:

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[253] *East London Own Haven t/a own Haven Housing Association v Coface South Africa Insurance Company Limited* [2011] ZAGPJHC 18 (22 March 2011). See Hugo (n 173) 130-132 for a very informative case discussion.

[254] par 37 (per Satchwell J – alteration and insertions by me).

[255] *East London Own Haven t/a Own Haven Housing Association v Coface South Africa Insurance Co Ltd* [2012] ZAGPJHC 182 (13 September 2012); and see Hugo and Marxen (n 138) 28-31 for a discussion of these proceedings and the judgment.

[256] As explained in par 6 of the SCA judgment.

[257] *Granbuild (Pty) Ltd v Minister of Transport and Public Works, Western Cape* [2015] ZAWCHC 83 (5 June 2015) par 18. See further *Joob Joob v Stocks* 2009 (5) SA 1 (SCA).

[258] See also Furst and Ramsey *Keating on Construction Contracts* (2012) 1197 par 21-271; and Bailey (n 226) 335 par 5.98 and 348 par 5.125.

[259] par 6.

> "It was accepted by Coface that there had been a mis-description by ELOH in relation to the payment certificate and that it was an interim certificate rather than a final one. Coface nevertheless contended that, notwithstanding that it was an interim certificate, it reflected a nil balance and thus became the final certificate because no further certificates had been issued."[260]

Coface effectively relied on the payment certificate and the recovery statement which indicated that the employer ELOH was owed no monies ("nil balance") by the contractor in respect of the construction contract and its cancellation. By attempting to introduce these events to the sphere of the guarantee, Coface sought to escape liability under the demand guarantee. In the High Court, Lamont J discussed the certification process in construction contracts and its relevance for the parties concerned, and eventually dismissed the application for the plea to be amended. He argued that in *Dormell Properties* the underlying dispute was settled with finality, making it "impossible for [Dormell] to establish an entitlement to the funds which underlay its claim for payment".[261] Distinguishing the case at hand, he held:

> "In the present matter the entitlement of the plaintiff to payment is not finally determined by the interim [certificate]. An interim certificate is subject to variation. There is accordingly not final determination as to the entitlement of the plaintiff to be paid damages. The interim certificate did not become a final certificate by reason of no further certification."[262]

The matter subsequently went on appeal to the Supreme Court of Appeal.[263] The court cited extensively and with approval from the English case *Edward Owen Engineering Ltd v Barclays Bank International Ltd*,[264] and the South African decisions *Loomcraft Fabrics CC v Nedbank Ltd*[265] and *Lombard Insurance Company Ltd v Landmark Holding (Pty) Ltd*[266] in support of the independent nature of both letters of credit and demand guarantees, and the limited grounds on which the principle of independence may be defeated.[267] Navsa ADP and Pillay JA then turned to the *Dormell Properties* judgment and held that the majority decision

[260] par 7.

[261] *East London Own Haven t/a Own Haven Housing Association v Coface South Africa Insurance Co Ltd* (n 255) par 15 (alteration and insertion by me).

[262] *East London Own Haven t/a Own Haven Housing Association v Coface South Africa Insurance Co Ltd* (n 255) par 15-16 (alteration and insertion by me).

[263] par 10.

[264] n 31.

[265] n 59.

[266] n 120.

[267] par 10-13.

"indicated a divergence" from these principles of the law governing demand guarantees.[268] They noted with concern:

> "Since the decision in Dormell and perhaps predictably, there has been an increasing number of cases in which guaranteeing banks have sought to introduce contractual disputes in order to avoid meeting the guarantee. In some cases the allegedly defaulting contractor sought to join the fray. It is the very consequence that the line of cases prior to Dormell sought to avoid."[269]

Therefore, in an unequivocal statement, the Supreme Court of Appeal held that "[t]he decision of the majority in Dormell was clearly wrong"[270] and dismissed Coface's efforts to rely on the recovery statement and the interim certificate stemming from the underlying contract to escape from its obligations.

The South African law after *Coface*

The *Coface* case overturned the majority decision in *Dormell Properties*. The judgment must be welcomed insofar as it clarified the confusion caused by *Dormell Properties*. While certainly correct on the material outcome, it is suggested that it did not settle satisfactorily all questions regarding a final determination of the underlying dispute and its potential legal impact on the guarantee.

In the first place, the judgment did not take a definite stance on a *truly final* payment certificate or recovery statement which, with absolute certainty and finality, determines all outstanding claims between the parties to the underlying construction contract.[271] As was explained by Lamont J, the *Coface* case revolved around an *interim* certificate.[272] Therefore, the case could readily be distinguished from *Dormell Properties*. The certificates and recovery statements in question were provisional and therefore not final. It was accordingly unnecessary for either of the courts to deal with the fact that the certificates and recovery statements were in existence at the time demand was made.[273]

[268] par 14.

[269] par 24.

[270] par 25 (alteration by me).

[271] Marxen (n 155) 143.

[272] *East London Own Haven t/a Own Haven Housing Association v Coface South Africa Insurance Co Ltd* (n 255) par 15-16.

[273] The cancellation of the construction contract occurred on 22 September 2008, followed by the issuance of the recovery statement (10 October 2008) and eventually the demand under the guarantee on 29 January 2009.

Conversely, the final determination of the underlying dispute through arbitration in *Dormell Properties* clearly took place well *after* the calling-up of the guarantee.[274] By overturning the majority decision in *Dormell Properties*, the Supreme Court of Appeal in the *Coface v East London Own Haven* case failed to deal with the legal position had the arbitral award been released and known to the parties *before* the demand. The following *dictum* of Cloete JA, however, is instructive:

> "[…] 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 been unjustified."[275]

This *dictum* is open for the interpretation that a beneficiary may well be acting in *bad faith* if it demands payment under the guarantee when the basis upon which the guarantee was called up has been found to have been *unjustified* in arbitration proceedings *prior to the demand*. Whether this is in fact the law in South Africa in the post-*Coface* era, however, is by no means certain. Moreover, even if this were to be the law, the question remains whether the beneficiary's bad faith in this context would be sufficient ground to allow an exception to the independence principle.[276]

The uncertainty in this regard is regrettable, and it is respectfully submitted that the Supreme Court of Appeal allowed an opportunity to pass to give better guidance (albeit *obiter*) on this important and uncertain aspect of commercial law. This is likely to lead in the future to further litigation relating to the final determination of the underlying dispute *before* the actual demand on the guarantee is made – be it by means of payment certificates, arbitral awards or other manner.[277] Until the Supreme Court of Appeal has determined this issue the position in South African law remains unsettled. The safest approach in the current state of affairs, it is suggested, is that the final-determination issue should be dealt with as a species

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See *East London Own Haven t/a own Haven Housing Association v Coface South Africa Insurance Company Limited* (n 253) par 5-6, and *East London Own Haven t/a Own Haven Housing Association v Coface South Africa Insurance Co Ltd* (n 255) par 4.

[274] See par 5.3.2 above.

[275] *Dormell Properties 282 CC v Renasa Insurance Co Ltd* (n 167) par 65 (omission, insertion and emphasis by me).

[276] In this context, regard must be had to the discussion of unconscionable conduct as a possible exception to independence. See par 5.6 *et seq* below.

[277] Marxen (n 155) 143 par d. For example, if the parties to the underlying contract reach a full settlement and the beneficiary nevertheless claims subsequently under the guarantee, German law would view the demand as *rechtsmissbräuchlich*. See Canaris (n 5) 775 par 1137; and Schütze "Zur Geltendmachung einer Bankgarantie 'auf erstes Anfordern'" 1981 *Recht der Internationalen Wirtschaft (RIW/AWD)* 83 85 par b.

of fraud as set out above: hence, since a demand with "knowledge of lack of entitlement" on the part of the beneficiary is fraudulent,[278] a truly final determination of the underlying dispute prior to the demand may be relevant evidence indicative of fraud should the guarantee be called up.

5.3.4 Perspectives from Germany and England

Under German and English law, the final determination of the underlying dispute can also have a legal bearing on the availability and validity of a demand under an independent guarantee.

Rechtsmissbrauch and documentary evidence in German law

In German law the point of departure, again, must be the doctrine of *Rechtsmissbrauch* (abuse of rights). As mentioned above this is the basis upon which German law deals with exceptions to the independence principle and other instances of abusive demands: if the beneficiary to a demand guarantee, with reference to the underlying relationship, clearly and obviously ("offensichtlich und liquide beweisbar") lacks material entitlement, its claim under the guarantee will be deemed abusive and thus subject to judicial intervention.[279] Therefore, an applicant wishing to preclude the beneficiary from drawing under the guarantee would need to build up a case of abuse which meets the criteria of *Rechtsmissbrauch*. This must be done with easily accessible evidence which shows immediately, and without any doubt, the lack of material entitlement to the money promised under the guarantee. For example, in a case before the *Oberlandesgericht Cologne* the court emphasised, in line with the law pronounced by the *Bundesgerichtshof*, the importance of documentary proof to substantiate the alleged abuse and lack of entitlement.[280]

To illustrate the position under German law, a typical scenario of final determination of the underlying relationship in the construction industry can be considered. The parties are in a

[278] See the discussion in par 5.2.5 above. Also, note the remark in Hugo "Bank guarantees" in Sharrock *The Law of Banking and Payment in South Africa* (2016) 437 454-455.

[279] For a detailed discussion of the doctrine of *Rechtsmissbrauch* see par 5.2.9 above.

[280] OLG Cologne 1988 *WM* 21 22.

prolonged dispute as to the quality of the works done by the contractor and stages of the contract that have been completed. They agree to refer their dispute to arbitration. In due course, and following proper procedures, the arbitral tribunal releases the award which finds in favour on the contractor. All allegations of defective work are held to be unfounded, and the award is clear that there can be no liability on the part of the contractor. The award further confirms that the construction works have been completed satisfactorily in their entirety. Following the release of the award, the employer decides to submit a demand under the guarantee. In the event of the contractor knowing this, it would in all probability resort to the courts and apply for (interim) relief,[281] that is a court order barring the employer from presenting and submitting the demand. In German law such an application is likely to succeed in these circumstances since the contractor would be able to present documentary and conclusive proof, in the form of the arbitral award, of the beneficiary's lack of entitlement.[282] This would satisfy the requirement of immediate and clear evidence.

In conclusion, thus, in accordance with German law and scholarly writing, the calling up of the guarantee can be interdicted by a court order if the applicant is able to adduce sufficient proof of the abusive conduct which should be preferably documentary in nature. An arbitral award, which settles all disputed facts and rules exhaustively on damages and liability, would suffice. Further relevant documentary evidence could be a written receipt issued by the beneficiary acknowledging full delivery and satisfactory performance, a final acceptance certificate by the contractually agreed-upon engineer, a document evidencing a full settlement of the underlying dispute by the parties, a quality certificate or a final judgment.[283] It is suggested that, as was pointed out above with regard to the discussion on South African law, the *time of the demand* is crucial. This means that sufficient evidence pointing towards the final determination of the underlying dispute, available prior to the time of the demand, can be seen as indicative of *Rechtsmissbrauch*.

[281] See par 3.4.2.6 above.

[282] See for example LG Düsseldorf 1985 *WM* 192 (arbitration found that beneficiary had to return the guarantee); OLG Oldenburg (n 143) 732 (arbitration denying entitlement and parties confirmed they would not claim); and Wessely (n 5) 65-66 par 162-163.

[283] BGH 1958 *WM* 696 697 ("rechtskräftiges Urteil"); OLG Frankfurt 1997 *WM* 609 610; OLG Celle (n 143) 1410; OLG Schleswig 1980 *WM* 48 50 (par c); Schütze and Edelmann *Bankgarantien* (2011) 152 (with reference to German case law and further sources); Canaris (n 5) 697 par 1018 and 775 par 1137; Schütze (n 277) 85 par b; Lohmann (n 125) 111; Ehrlich and Haas (n 146) 469 par 9/125; and Wessely (n 5) 65-66 par 162.

Final determination in English law

There has been no English case law dealing with issues of final determination of the underlying dispute, and its potential impact on the demand guarantee.[284] It is suggested, however, that the matter is likely to be approached, as in South Africa, from the perspective of the fraud exception.[285] The notion that a demand is fraudulent if it is submitted by the beneficiary without an "honest belief" in its material validity, will accordingly be especially relevant.[286] Hence, if there has been comprehensive and clearly final determination of the underlying dispute in some or other manner, a subsequent demand may well be one made in the absence of an honest belief in material entitlement, and, as such, constitute fraud.[287]

Although the discussion of the South African law in this respect dealt with fraud in the form of "knowledge of lack of entitlement" as opposed to the English formulation of fraud as the absence of an "honest belief", it is submitted that in this context these two phrases mean very much the same.

5.3.5 Summary and conclusion

As emerges from what was said above, the final determination of the underlying construction dispute can, in accordance with South African law, have an impact on the right of the beneficiary to call up the guarantee. The *Dormell Properties* and *Coface v East London Own Haven* cases are especially relevant in this regard. Despite the fact that both cases dealt

[284] In his impressive book Bertrams (n 7) 409 par 14-50 makes only reference to foreign case law and an arbitral award. Further, the decision in *Petrosaudi Oil Services (Venezuela) Ltd v Novo Banco SA* [2016] EWHC 2456 (Comm), if possibly a case in point, was overturned on appeal in *Petrosaudi Oil Services (Venezuela) Ltd v Novo Banco SA* [2017] EWCA Civ 9.

[285] See the discussion in par 5.2.3 above.

[286] Regard may be had, for example, to *Alternative Power Solution Ltd v Central Electricity Board* (n 47); *Uzinterimpex JSC v Standard Bank Plc* (n 45); *Edward Owen Engineering Ltd v Barclays Bank International Ltd* (n 31); *United Trading Corporation SA v Allied Arab Bank Ltd* (n 34); *Banque Saudi Fransi v Lear Siegler Services Inc* (n 36); and *ESAL (Commodities) Ltd v Oriental Credit Ltd* (n 36).

[287] See the elaborations in par 5.3.3 above. Note that Hugo (n 196 *TSAR*) 666 has argued that the final determination of an underlying dispute, for instance via arbitral award, "especially if known to the beneficiary prior to the demand, can be indicative of the absence of an honest belief on the part of the beneficiary that it is entitled to demand payment under the guarantee. As such it can open the door to the fraud exception." Similar also Bertrams (n 7) 409 par 14-50. Regard may also be had to *Petrosaudi Oil Services* case (n 284 *2016*), especially par 86 and 88. Although overturned on appeal (n 284 *2017*), it supports, to a degree, the observation made here.

specifically with this issue, however, some questions remain unresolved.[288] The most crucial relates to the effect of a truly final determination of the underlying dispute preceding the calling up of the guarantee. It is suggested that the law in this regard should be developed with reference to the fraud exception: "knowledge of the lack of entitlement"[289] on the part of the beneficiary may render the call fraudulent.

In German law, it is crucial for an applicant to meet the requirements of the *Rechtsmissbrauch* doctrine if it wishes to interdict the guarantor or beneficiary from making or demanding payment on the basis of a final determination of the underlying dispute. If it can adduce documentary evidence (a final arbitral award or conclusive final certificate) in its favour which shows the beneficiary's clear lack of material entitlement under the guarantee, prior to the demand, it is likely to succeed.

The matter has not received the attention of the courts or commentators in English law as yet. It is suggested that the position is likely to be similar to that in South African law. Hence, if due to the final determination of the underlying dispute the beneficiary has no "honest belief" in its entitlement to call up the guarantee, an injunction should be possible.

5.4 Illegality of the underlying contract

5.4.1 Introduction

Illegality of the underlying construction contract could conceivably be a basis upon which the independence of demand guarantees may be attacked. In a construction setting, several issues must be borne in mind which could potentially lead to the illegality of the construction contract,[290] including the following: the awarding of a tender may have been induced by fraud, misrepresentation or corruption;[291] the prescribed procurement process for service

[288] See par 5.3.3 above.

[289] See par 5.2.5 above.

[290] Although it has been claimed that engineering and construction contracts are rarely illegal (Loots *Construction Law and Related Issues* (1995) 52 par 2.7), the question of illegality of the underlying contract and pursuant to it a potentially abusive demand on a guarantee cannot be left unaddressed.

[291] Ramsden (n 164) 66-67 par 5.6.

contracts may have been ignored or violated;[292] a compulsory environmental compliance assessment may have been omitted or failed; the necessary licence or permission for engineering projects may not have been granted; a building may not have complied with the applicable building code and zoning laws;[293] and international embargoes and sanctions prohibiting payment for or the supply of certain facilities, structures, materials or works may have been contravened.[294] Such contraventions of the law could render the underlying contract illegal and, depending on the applicable legal system, claims relating to performance and payment – under the construction contract itself – unenforceable.[295]

The legal effect, however, of suchlike illegality on the independent obligation under a demand guarantee, is more contentious. The independence principle would, naturally, militate against such an attempt to resist enforcement of this type of abstract security instrument on the basis of an illegal underlying transaction. As long as the demand complies with the guarantee itself and any documentary conditions contained therein, the issuer is compelled to pay. On the other hand, insulating the guarantee from the illegality of the underlying contract would have the unsatisfactory effect of enabling the beneficiary to receive payment for an illegal transaction. It is suggested that this conflict should essentially be resolved on the basis of considerations of public policy. The question has not yet arisen in South African case law. English law, and German law, however, provide helpful guidance in this regard.

[292] In this regard s217 (1) of the Constitution of the Republic of South Africa is particularly relevant; see also the deliberations in the recent case of *Kwa Sani Municipality v Underberg/Himeville Community Watch Association* [2015] 2 All SA 657 (SCA).

[293] Uff (n 203) 196-197.

[294] Bertrams (n 7) 345-347 par 13-42 and 398-399 par 14-41; Blesch and Lange (n 132) 275-302; Richardson "Between a rock and a hard place? When a payment under a letter of credit is affected by a sanction, money-laundering or terrorism financing" 2008 *Butterworths Journal of International Banking and Financial Law* 341 342-343; and LG Essen 1999 *WM* 178. See also, to a certain extent, Rüßmann "Auslandskredite, Transferverbote und Bürgschaftssicherung" 1983 *WM* 1126 1127 *et seq*.

[295] Bridge (n 29) 165 par 3-027 and 166 par 3-029; Ramsden (n 164) 67-70 par 5.7-5.8; Uff (n 203) 196-197; McKendrick (n 49) 144; and Loots (n 290) 52-53 par 2.7. Regarding the important question of burden of proof when alleging illegality in a contract see Du Plessis "Illegal contracts and the burden of proof" 2015 *SALJ* 664 *et seq*.

5.4.2 English law

In the case of *United City Merchants (Investments) Ltd v Royal Bank of Canada (The American Accord)*,[296] the court examined a scenario in which a letter of credit was utilised to pay in a sale transaction which made use of inflated invoices in order to circumvent statutory exchange control regulations. The regulations that were contravened were Peruvian (and thus not part of English law).[297] However, the United Kingdom had implemented and accepted the Bretton Woods Agreement as having "the force of law in England".[298] Article VIII section 2(b) of the Bretton Woods Agreement was quoted by Lord Diplock to emphasise the regard that the United Kingdom had to have for foreign exchange control statutes of friendly nations:

> "Exchange contracts which involve the currency of any member and which are contrary to the exchange control regulations of that member maintained or imposed consistently with this agreement shall be unenforceable in the territories of any member…"[299]

Lord Diplock refrained from classifying the transaction in contravention of the exchange control act as truly "illegal", but nevertheless refused enforcement insofar as the transaction contravened the exchange control regulation:

> "If in the course of the hearing of an action the court becomes aware that the contract on which a party is suing is one that this country has accepted an international obligation to treat as unenforceable, the court […] must refuse to lend its aid to enforce the contract. But this does not have the effect of making an exchange contract that is contrary to the exchange control regulation of a member state other than the United Kingdom into a contract that is 'illegal' under English law or render acts undertaken in this country in performance of such a contract unlawful. Like a contract of guarantee of which there is no note or memorandum in writing it is unenforceable by the courts and nothing more."[300]

The court was unequivocally in favour of allowing a bank to resist a claim for payment under a letter of credit if, and as far as, it is aware of the transaction being a monetary operation contrary to exchange control regulations.[301] Although this case concerned a letter of credit and not a demand guarantee, and the court did not deem the transaction to be "illegal" but merely "unenforceable", one can assume that a case involving a demand guarantee would be

[296] n 17.

[297] 182D-E.

[298] 188E.

[299] 188F.

[300] 189B-C (omission by me).

[301] 190E-F (the other Lords concurring in Lord Diplock's judgment at 190-191).

treated similarly. Hence the English courts are likely to deny a claim under a demand guarantee if the underlying transaction is illegal. In fact, "illegality" is not an absolute requirement; the *United City Merchants* case provides authority for the view that the contravention of a foreign statutory provision, in conjunction with the Bretton Woods Agreement, may be sufficient.[302]

Further clarity arises from *Group Josi Re Co SA v Walbrook Insurance Co Ltd*,[303] were the English law regarding the consequences of illegality of underlying reinsurance contracts on letters of credit connected to these contracts was dealt with. With reference to the *United City Merchants* case, Staughton LJ held:

> "But it does perhaps show that established fraud is not necessarily the only exception. It seems to me that there must be cases when illegality can affect a letter of credit. Take for example a contract for the sale of arms to Iraq, at a time when such a sale is illegal. The contract provides for the opening of a letter of credit, to operate on presentation of a bill of lading for 1,000 Kalashnikov rifles to be carried to the port of Basra. I do not suppose that a court would give judgment for the beneficiary against the bank in such a case."[304]

He continued as follows:

> "Turning to the present case, if the [underlying] reinsurance contracts are illegal, and if the letters of credit are being used as a means of paying sums due under those contracts, and if all that is clearly established, would the court restrain the bank from making payment or the beneficiary from demanding it? In my judgment the court would do so. That would not be because the letter of credit contracts were themselves illegal, but because they were being used to carry out an illegal transaction."[305]

Group Josi Re Co SA v Walbrook Insurance Co Ltd, it is submitted, is a laudable judgment on this particular point. It demonstrates general appreciation for the notion of independence and the fundamental understanding that the two transactions (the underlying contract and the letter of credit) give rise to separate obligations operating under different legal premises. In addition the decision makes use of a fitting example of a transaction which provides a convincing argument against the impenetrable separation of the underlying transaction and the letters of credit. The judgment, on considerations of public policy, recognises the need to disregard and limit the independence principle in certain, extraordinary instances.[306]

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[302] Therefore, it is superfluous to investigate and clarify the legal state of contracts which are contravening such control regulations without being classified as "illegal".

[303] (n 23 *1996*).

[304] 1164.

[305] 1164 (my insertion).

[306] It must be noted, however, that the court eventually held that the reinsurance transactions in the case at hand were not illegal.

This reasoning was developed further in the *Mahonia* cases.[307] In these cases, the Queens's Bench Division Commercial Court ruled on the enforceability of a standby letter of credit which secured and facilitated a so-called credit swap agreement. To circumvent United States accounting regulations and disguise a certain financial transaction, several companies entered into an agreement secured by a standby letter of credit agreement which was effectively a loan for the duration of six months. In order to hide the financial exposure and financial state of certain entities involved, the parties resorted to a standby letter of credit to secure repayment of what was effectively a loan. When the debtor filed for protection under bankruptcy statutes, the beneficiary called up the standby letter of credit. The issuing bank, however, resisted the demand for payment and pleaded the illegality of the underlying transaction as a defence. In the first *Mahonia* judgment,[308] which essentially had to determine whether this defence had to be struck on the basis of being incompetent, Colman J held:

> "there is a real conflict between on the one hand the well-established principle that contracts lawful on their face which are entered into in furtherance of an illegal purpose will be unenforceable at the suit of the party having knowledge of that purpose at the time of contracting and on the other hand the policy of the law reflected in all the letter of credit cases of preserving the impregnability of the letter of credit save where the bank has clear evidence of an ex turpi causa defence such as fraud."[309]

He elaborated further:

> "I find it almost incredible that a party to an unlawful arms transaction would be permitted to enforce a letter of credit which was an integral part of that transaction even if the relevant legislation did not on its proper construction render ancillary contracts illegal. […] If a beneficiary should as a matter of public policy (ex turpi causa) be precluded from utilizing a letter of credit to benefit from his own fraud, it is hard to see why he should be permitted to use the courts to enforce part of an underlying transaction which would have been unenforceable on grounds of its illegality if no letter of credit had been involved, however serious the material illegality involved. To prevent him doing so in an appropriate serious case such as one involving international crime could hardly be seen as a threat to the lifeblood of international commerce."[310]

Colman J therefore refused to strike out the illegality defence.[311] In the second *Mahonia* case which addressed the merits of the defence *in casu*, Cooke J generally subscribed to the legal reasoning by Colman J:

> "the Court ought not and will not lend its aid to enforce a contract, a security or something akin to a security for a contract, where the underlying purpose of that contract is contrary to the law of a friendly

[307] *Mahonia Ltd v JP Morgan Chase Bank* [2003] 2 Lloyd's Rep 911; and *Mahonia Ltd v JP Morgan Chase Bank, West LB AG* [2004] EWHC 1938.

[308] *Mahonia Ltd v JP Morgan Chase Bank* (n 307).

[309] 927 par 68.

[310] 927 par 68 (alteration and omission by me).

[311] 928 par 70.

> foreign state where performance is to occur and the gravity of that unlawfulness is such as to engage public policy considerations."[312]

However, because the court eventually found that illegality in the sophisticated credit swap agreements and accounting practice by the parties involved in the underlying transactions was not proven,[313] the cited paragraph is "strictly speaking, obiter".[314] Nevertheless, it is submitted that in principle English law has accepted that in fitting circumstances illegality of the underlying contract may provide a valid defence to claims under letters of credit and demand guarantees.[315] This will be the case if the contraventions of the law are grave and serious enough to warrant intervention based on public policy considerations.[316] Hence, under English law, parties to a construction contract or another agreement which is void by virtue of being illegal, may in principle be injuncted from making payment, demanding or receiving money under a demand guarantee securing the underlying, illegal transaction, and the guarantor may be successful, if sued, in relying on the illegality as a defence.

5.4.3 South African law

South African courts have not had the opportunity to deliberate on illegality of the underlying contract as a defence to claims under demand guarantees.[317] Hugo observed that

[312] *Mahonia Ltd v JP Morgan Chase Bank, West LB AG* (n 307) 431.

[313] 423 *et seq*.

[314] Enonchong "The autonomy principle of letters of credit: an illegality exception?" 2006 *LMCLQ* 404 410 (his italics omitted).

[315] Horowitz (n 21) 224 par 7.80; and Hugo "Documentary credits and independent guarantees" 2005 *Annual Banking Law Update* 1 and 15. See also the remarks in *Oliver v Dubai Bank of Kenya* [2007] EWHC 2165 per Smith J at 12. Others, however, are seemingly less confident that English law has unconditionally accepted the illegality defence: Enonchong (n 15) 192 par 8.21 ("the position of English law is less than settled, even after *Mahonia*"); and Enonchong (n 314) 410. Writing in 2002, Löw *Missbrauch von Bankgarantien und vorläufiger Rechtsschutz* (2002) 99 (par V) even seems to disagree. But note also her further elaborations at 100-101. For strong criticism of the acceptance of the illegality defence in English law, see Johns and Blodgett "Fairness at the expense of commercial certainty: the international emergence of unconscionability and illegality as exceptions to the independence principle of letters of credit and bank guarantees" 2001 *Northern Illinois University Law Review* 297 328 *et seq*.

[316] Bertrams (n 7) 401-403 par 14-44; Mugasha "Enjoining the beneficiary's claim on a letter of credit or bank guarantee" 2004 *The Journal of Business Law* 515 524; and Mugasha (n 15) 189-190.

[317] Kelly-Louw (n 58 *2014*) 200; and Kelly-Louw "Illegality as an exception to the autonomy principle of bank demand guarantees" 2009 *CILSA* 339 379-380 and 385. Regard may be had to *KNS Construction (Pty) Limited (in liquidation) v Mutual and Federal Insurance Company Limited* [2015] JOL 32725 (GJ) as discussed in Van Niekerk and Schulze (n 21) 297-298 par 3.9.3.5. Note, however, that this judgment was overturned by the SCA in *Mutual and Federal v KNS Construction* [2016] ZASCA 87 (31 May 2016).

> "the assumption that an illegal underlying transaction may provide an exception to the independence principle […] [was accepted in English case law] but not as yet by our [South African] courts".[318]

Two different legal approaches seem to offer reasonable solutions. South African courts could, in the first place, follow the English route and subscribe to the notion that a beneficiary may not abuse the courts to give effect to a security instrument which underpins a clearly illegal, unenforceable transaction.[319] For the reasons stated by Coleman J in the first *Mahonia* case,[320] it would be difficult to argue that judicial intervention in such cases of illegal transactions would constitute a "threat to the lifeblood of international commerce". On the contrary, the effective prevention of such illegal activities would rather foster confidence and thus international commerce in general.[321] The second potential approach would be to fall back on the fraud exception as developed in the context of demand guarantees. If the heart of fraud is a demand made in the knowledge of no material entitlement to proceeds of the guarantee, the illegality of the underlying contract could pave the way for the fraud exception in fitting circumstances (available proof of intent to act fraudulently by relying on the illegal transaction).[322] In the absence of case law to the point,[323] however, the position in South Africa is not entirely clear. Academic writing, correctly it is submitted, seems to be in support of accepting the illegality defence as part of the South African law of demand guarantees.

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[318] (n 216 *2014*) 59 (alteration, omission and insertions by me).

[319] This seems to be favoured by South African writers. See Van Niekerk and Schulze (n 21) 291 par 3.9.2; and Kelly-Louw (n 317 *2009*) 381 and 385-386 (although she argues for the additional requirement of a "clear criminal element" to be included in the illegal transaction in order to narrow the scope of the exception to independence). Additionally, South African courts regularly "relied strongly on English precedent in cases dealing with independent guarantees and letters of credit", which lends even more support for such a suggestion; see Hugo (n 83) 159 (as well as 162 and 173).

[320] *Mahonia Ltd v JP Morgan Chase Bank* (n 307).

[321] Antoniou "Beyond the American Accord: Making the way for illegality in letters of credit" 2015 *Journal of International Banking Law and Regulation* 189 194 ("the illegality defence, particularly in serious illegal transactions, is not a threat to international commerce but quite possibly a blessing"); and Lurie "On-demand performance bonds: is fraud the only ground for restraining unfair calls?" 2008 *The International Construction Lawyer* 443 465. Further, note also the remarks in Hugo (n 196 *TSAR*) 674 ("Finally, it is necessary to bear in mind that the blocking of an artery may indeed be beneficial"). Although his remarks did not relate directly to the illegality defence in demand guarantees they are equally relevant, it is suggested, for the particular discussion at hand.

[322] See Kelly-Louw (n 317 *2009*) 381 and 385-386 ("clear criminal element"); and Ramsden (n 164) 67 par 5.7. Also note Proctor's suggestion as to how the fraud exception could capture a case like *Mahonia* ("Enron, letters of credit and the autonomy principle" 2004 *Butterworths Journal of International Banking and Financial Law* 204 206-208).

[323] The decision in *KNS Construction (Pty) Limited (in liquidation) v Mutual and Federal Insurance Company Limited* (n 317), even if possibly a case in point, was overturned by the SCA in *Mutual and Federal v KNS Construction* (n 317).

Legal certainty, however, will only be achieved by means of an authoritative judgment in point.[324]

5.4.4 German law

In German law the illegality of the underlying contract can have an impact on the availability of an abstract security instrument which was created to secure the transaction. As early as in 1923 the German *Reichsgericht* confirmed the guarantor's right to refuse payment in cases where the underlying transaction clearly violates the law and public order.[325] In due course thereafter the jurisprudence regarding the effect of illegal underlying contracts on demand guarantees and other abstract obligations was developed with reference to the German doctrine of abuse of rights (*Rechtsmissbrauch*).[326] In this case the *BGH* had to decide an appeal regarding an international sale of shoes which was in violation of statutory anti-counterfeiting provisions. The court held, however, that the violation of the statutory law did not invalidate the underlying contract in its entirety, and thus denied the applicability of the *Rechtsmissbrauch* doctrine. Nevertheless, the court appreciated the general notion that voidness of the underlying contract due to illegality could be a valid defence.

Furthermore, German courts, akin to the position in English law, would probably deny enforcement of guarantees or documentary credits if the underlying transaction were to violate the Bretton Woods Agreement and currency exchange control regulations of other member states. Generally, the *BGH* has rejected a claimant's right to institute legal action if the cause of action stems from a contract which is in violation of the Bretton Woods or other international currency exchange control agreements.[327] There is support for the notion that the

[324] Accordingly, one would have to agree with Hugo and his disappointment in regard to *Casey v Firstrand Bank Ltd* 2014 (2) SA 374 (SCA), where no general guidance on illegality as a defence was provided by the South African Supreme Court of Appeal. See Hugo (n 216 *2014*) 59.

[325] RG *RGZ* 106, 304 at 307-308 (note, however, that the *Reichsgericht* did not discuss and utilise the doctrine of *Rechtsmissbrauch* which was, in regard to the field of letters of credit and demand guarantees, only developed later).

[326] BGH 1996 *WM* 995 996. For the doctrine of *Rechtsmissbrauch* see par 5.2.9 above.

[327] BGH 1964 *WM* 768; BGH 1970 *NJW* 1507 1508; BGH 1991 *NJW* 3095 3096; and BGH 1994 *NJW* 390. See further OLG Düsseldorf 1983 *WM* 1366 1368-1369.

unenforcability of the underlying transaction, due to violations of currency exchange control regulations, could also invalidate claims on the guarantee.[328]

Accordingly, if the illegality of the underlying contract indicates an obvious and unquestionable lack of material entitlement on the part of the beneficiary of a guarantee or letter of credit, this may provide a defence to a claim for payment, or the factual basis for an injunction preventing payment or a demand for payment. Scholars mostly approve of the illegality exception,[329] provided it does not burden the guarantor with an obligation to investigate the underlying contract which is seen as cumbersome, unpractical and contrary to the notion that banks should not get involved in the underlying contractual relationship between the applicant and beneficiary.[330] The application of the illegality exception in German law, however, is restricted to cases in which clear evidence of the illegality is immediately available. This is entirely in line with the general requirements of the abuse-of-rights doctrine which always necessitates immediate and manifestly clear evidence of the abuse.

5.5 Prescription of underlying claim (or impact of statute of limitation)

The prescription of the underlying claim arising from the construction contract can potentially lead to disputes as to the validity of the demand under a guarantee. The issue that may arise in this context is whether the applicant can conceivably prevent payment of the guarantee on the basis of the underlying obligation having prescribed.

The question regarding the effect of prescription of a claim arising from the underlying construction contract on the demand guarantee has received significantly more attention in German law than in South African and English law. In German law, prescription

[328] Graf von Westphalen and Zöchling-Jud (n 90) 224-225 par 244-246; Schimansky, Bunte and Lwowski *Bankrechts-Handbuch Band II* (2011) §121 (Bankgarantien bei Außenhandelsgeschäften) 2242-2243 par 152; Canaris (n 5) 697-698 par 1019 and 774-775 par 1137; and Lohmann (n 125) 116-117. The judgment in BGH (n 327 *1964*) 768, on the other hand, is most likely not good authority for this claim (illegality affecting both underlying relationship and guarantee) as it concerned a transaction secured by a guarantee which was not abstract and autonomous in nature. See especially at 770 par e.

[329] Graf von Westphalen and Zöchling-Jud (n 90) 224 par 244; Ehrlich and Haas (n 146) 266 par 2/412 (letters of credit and illegality) and 471-472 par 9/128 (demand guarantees, although more reluctantly); Canaris (n 5) 697 par 1019 and 774-775 par 1137; Schärrer *Die Rechtsstellung des Begünstigten im Dokumenten-Akkreditiv* (1980) 133; Lücke (n 202) 184; and Wessely (n 5) 69 par 170.

[330] Schütze and Edelmann (n 283) 117 par 1.3; and Wessely (n 5) 69 par 170. Hugo (n 5) 264 (par illegality) supports Wessely.

("*Verjährung*") requires the debtor to plead the defence and should the requirements for prescription be fulfilled, it does not extinguish the debt in its entirety but renders the claim unenforceable.[331] This is a result of the defence's general *weakness*. Prescription as a legal objection against claims for payment or performance is often restricted.[332] In this regard, and specifically with reference to secured claims such as those under letters of credit or demand guarantees, paragraph 216 of the BGB is important:

> "§ 216 Wirkung der Verjährung bei gesicherten Ansprüchen
>
> (1) Die Verjährung eines Anspruchs, für den eine Hypothek, eine Schiffshypothek oder ein Pfandrecht besteht, hindert den Gläubiger nicht, seine Befriedigung aus dem belasteten Gegenstand zu suchen.
>
> (2) *Ist zur Sicherung eines Anspruchs ein Recht verschafft worden, so kann die Rückübertragung nicht auf Grund der Verjährung des Anspruchs gefordert werden*. Ist das Eigentum vorbehalten, so kann der Rücktritt vom Vertrag auch erfolgen, wenn der gesicherte Anspruch verjährt ist.
>
> (3) Die Absätze 1 und 2 finden keine Anwendung auf die Verjährung von Ansprüchen auf Zinsen und andere wiederkehrende Leistungen."[333]

Paragraph 216 (2) BGB is especially relevant. Although it considers the *retransfer* of security rights after prescription of the underlying claim ("so kann die *Rückübertragung* nicht auf Grund der Verjährung des Anspruchs gefordert werden"),[334] it may also influence the *validity* of demands on these security rights. If the retransfer of a security right cannot be demanded despite the limitation of the underlying claim, the calling up of the security must clearly still be permissible. Some scholars argue, however, that paragraph 216 (2) is only concerned with so-called "Realsicherheiten".[335] So viewed, "Personalsicherheiten"[336] such as a demand

[331] Gursky, Jacoby, Peters, Repgen and Schilken *J von Staudingers Kommentar zum Bürgerlichen Gesetzbuch Allgemeiner Teil 5* (2014) 882 par 1 and 909-910 par 1; Vygen and Joussen *Bauvertragsrecht nach VOB und BGB* (2013) 979 par 2685; and Säcker *Münchener Kommentar zum Bürgerlichen Gesetzbuch Band 1* (2015) intro paragraph 194 par 1 and 5, and paragraph 214 par 1.

[332] Further, performance or payment made under a prescribed obligation may not be reclaimed: see par 214 (2) BGB. Set-off against prescribed claims is still possible under certain circumstances: see par 215 BGB.

[333] Paragraph 216 BGB Effect of Limitation in the Case of Secured Claims:

(1) The limitation of a claim for which a mortgage, ship mortgage or security right exists does not prevent the obligee from seeking satisfaction of his claim from the object encumbered.

(2) *If a right has been procured for the purpose of securing a claim, the retransfer of the right may not be demanded on the basis of the limitation of the claim.* If title has been retained, the right to revoke the contract may be exercised even if the secured claim is statute-barred.

(3) Subsections (1) and (2) above do not apply to the limitation of claims for interest and other recurring obligations. (Translation by the Langenscheidt Translation Service, www.gesetze-im-internet.de/englisch_bgb; my emphasis).

[334] Paragraph 216 (2) BGB "[…] the retransfer of the right may not be demanded on the basis of the limitation of the claim".

[335] Real security rights. Gursky, Jacoby, Peters, Repgen and Schilken (n 331) 912 par III.

guarantee would fall outside the ambit of paragraph 216 (2) BGB. The *Bundesgerichtshof*, however, appears not to agree with this interpretation. In a recent judgment[337] concerning a so-called "notarielles Schuldanerkentnis"[338] and a so-called "Schuldversprechen mit Vollstreckungsunterwerfung"[339], the court had to determine whether these abstract payment obligations – which share certain legal characteristics with demand guarantees[340] – are rendered unenforceable due to the underlying claim having prescribed. Although paragraph 216 (2) was *not* held to be *directly* applicable,[341] the court held that the paragraph was *applicable by analogy* and, consequently, that such "abstrakte Schuldversprechen" remain enforceable despite the prescription of the underlying claim.[342] The same reasoning is likely to be applied to demand guarantees.[343]

In German law, cases of prescription of the underlying debt could conceivably be approached also through the doctrine of abuse of rights (*Rechtsmissbrauch*). Accordingly, if the underlying claim has clearly and undisputedly prescribed, and the beneficiary is aware of its lack of (enforceable) material entitlement, and yet claims under the guarantee, one could argue that the doctrine of abuse of rights would render the call on the guarantee invalid.[344] In a case before the *Oberlandesgericht Düsseldorf*, however, the point was made that prescription of the underlying claim will seldom be evident and obvious beyond doubt, and, therefore, a case based on prescription will seldom be able to satisfy the high standards of an obvious and blatant abuse of rights as required by the doctrine of *Rechtsmissbrauch*.[345]

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[336] Personal security rights (my translation).

[337] BGH 2010 *WM* 28 30 *et seq*; confirmed in BGH 2010 *WM* 308 310 *et seq*.

[338] Acknowledgement of debt recorded by a notary public (my translation).

[339] Formal promise of performance with declaration of immediate enforcement (my translation).

[340] Such as the abstract nature of the undertaking.

[341] par 21.

[342] par 22 *et seq*. Legal commentators have criticised this particular judgment. See Säcker (n 331) paragraph 216 par 4.

[343] Panagiotopoulos (n 132) 63 par (2), especially his last three sentences; and Schütze and Edelmann (n 283) 100 par 6.

[344] On the doctrine of *Rechtsmissbrauch* (abuse of rights) see par 5.2.9 above.

[345] OLG Düsseldorf 2001 *WM* 2294 2296 ("Der Eintritt der Verjährung ist wegen der vielfältigen gesetzlichen Hemmungs- und Unterbrechungsgründen nicht allein aufgrund der Dauer der Verjährungsfrist für jedermann offensichtlich"). This case was also dealt with by Bertrams in his excellent text book on demand guarantees. Bertrams' analysis of this case, with respect, is probably insufficient as the court did not reject defences based on prescription *per se*, but rather emphasised the high threshold for evidence to be admissible and convincing. Therefore, the statement in Bertrams (n 7) 405 par 14-46 ("even proper evidence that the beneficiary/creditor's cause of action against the applicant/debtor in respect of the secured contract is time-

Against this background it must be appreciated that the impact of prescription of the claim on the underlying contract on the demand guarantee is not entirely clear in German law. If there is compelling evidence of a *Rechtsmissbrauch*,[346] the judgment of the *Oberlandesgericht Düsseldorf* suggests that a claim under the guarantee may be defeated.[347] On the other hand, and with reference to the *BGH* case,[348] the provision of paragraph 216 (2) of the BGB may be applicable which would lead to the conclusion that the abstract demand-guarantee claim is still available despite the underlying claim having prescribed. This approach is in accordance with the principle of independence and is therefore preferable.

Incidentally, this position would be similar to the approach in Malaysian law: In *Cimb Bank Berhad v Norlia Binti Mohd Yusof*,[349] a banking facility agreement was reached in 1998 which extended a letter of credit to the borrower. Repayment/reimbursement was guaranteed by a third party. Banking facilities were revoked in 2001, and the borrower was liquidated in 2005. The guarantor refused to pay out the guarantee, and was sued. The Malaysian High Court allowed the claim, despite the guarantor raising the defence of – *inter alia* – limitation of action since the underlying repayment claim was clearly time-barred. A similar legal interpretation was favoured in *Tenaga Nasional Bhd v Pearl Island Resort Development Sdn Bhd*.[350] After a company supplied electricity to a sports club, an instalment plan was negotiated for the payment of outstanding utility bills. The club, through its bank, had a demand guarantee issued in favour of the electricity supplier. The beneficiary claimed under the guarantee and also sued the club for the outstanding balance. The court found that, inter alia, the drawing on the guarantee was permissible despite the underlying claim for payment being time-barred. The court stressed the separateness of the two contracts (the underlying agreement between the club and the supplier as opposed to the abstract promise between the bank and the supplier).

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barred on account of the statutory provisions on limitations of actions does not constitute a defence against payment under the guarantee") is not necessarily correct.

[346] OLG Düsseldorf (n 345) 2296.

[347] The material outcome of this approach would be similar to the position in Singaporean law: In *Econ Piling v Aviva General Insurance* [2006] 4 SLR 501, the Court of Appeal held that the prescription of the underlying claim also bars the demand on a guarantee. Although the case at hand dealt with an instrument akin to a suretyship, the court made plain that the same rule would apply to a truly independent guarantee (par 24).

[348] (n 337 *WM 28*).

[349] [2013] MLJU 471. Note, that the case facts reported here originate from Byrne, Byrnes, Brown and Traisak *2014 Annual Review of International Banking Law and Practice* 417.

[350] [2013] MLJU 812. Case facts taken from Byrne, Byrnes, Brown and Traisak (n 349) 549.

In South Africa, the Supreme Court of Appeal, in *Casey v Firstrand Bank Ltd*,[351] recently had the opportunity to consider the issue in general. Although the litigation did not originate from a construction scenario but a loan agreement, the case added value to the general understanding of demand guarantees. The case was concerned with a standby letter of credit.[352] In order to secure a loan by Firstrand Bank to Kimberley Roller Mills (Pty) Ltd, a business partner of Kimberley – a certain Paul Casey – instructed his bank (Bank of America) to issue a standby letter of credit in favour of Firstrand Bank. The credit facilities granted to Kimberley Roller Mills in 1998 were never claimed back or revoked by Firstrand Bank; the expiry date and amount of the standby letter of credit were simply adjusted from time to time. Eventually Firstrand Bank cancelled the credit facilities, and requested payment of all outstanding debts. Casey, being the applicant for the standby letter of credit, contended that the underlying debt had prescribed, that the requested amount was in violation of the *in duplum* rule,[353] and that the call on the security instrument was invalid.

South African law subscribes to a so-called *strong* principle of prescription, meaning an obligation is extinct upon prescription.[354] Nevertheless, if payment is made on a debt which had prescribed, recovery or demand for repayment of such payment is not permissible.[355] Also, while suretyship contracts securing the underlying obligation share the fate of extinction upon prescription of the underlying debt,[356] this is probably not so in terms of independent, abstract instruments of security or payment.

[351] n 324.

[352] See par 3.2.2 above.

[353] The requested amount included interest and thus invited legal questions concerning the *in duplum* rule. See Kelly-Louw (n 58 *2014*) 208-210.

[354] Prescription Act 68 of 1969. Christie and Bradfield *Christie's The Law of Contract in South Africa* (2011) 501 and 503; Hutchison and Pretorius *The Law of Contract in South Africa* (2012) 389 par 15.4.4.5; Van Huyssteen and Maxwell *Contract Law in South Africa* (2015) 214 par 471; Visser *Unjustified Enrichment* (2008) 755 par 2(a); and Du Bois *Wille's Principles of South African Law* (2007) 852 par (a).

[355] Visser (n 354) 755-756 par 2(a) calls the South African approach to prescription "weak" in this particular regard. Similar also Hutchison and Pretorius (n 354) 389 par 15.4.4.5; Du Plessis *The South African Law of Unjustified Enrichment* (2012) 124 par 4.3.3.4; Van Huyssteen and Maxwell (n 354) 214 par 471; and Du Bois (n 354) 853 (a).

[356] Prescription Act 68 of 1969 sec 10(2); Christie and Bradfield (n 354) 504; and Du Bois (n 354) 853 (a).

In any event, the SCA stressed the independence of the obligation of the Bank of America under the standby letter of credit and, with reference to *Loomcraft Fabrics CC v Nedbank Ltd*,[357] held:

> "[…] a letter of credit is wholly independent of the underlying contract between the customer of the bank and the beneficiary. It establishes a contractual obligation on the part of the issuing bank to pay the beneficiary in accordance with its terms. 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."[358]

Further, Swain AJA explained:

> "To claim a draw-down on the letter of credit Firstrand simply had to state that Kimberley had not met its obligations in respect of the facilities granted to it by Firstrand and that a specified amount was due and payable to Firstrand. Firstrand complied with the letter of credit, obliging the Bank of America to honour its undertaking and make payment."[359]

The court furthermore investigated the need to pronounce on the alleged prescription of the underlying debt, and its potential legal effect on the standby letter of credit. It finally decided the issue to be moot:

> "Whether the claim of Firstrand had prescribed […], would only be of relevance if Firstrand acted fraudulently. It would have to be established that Firstrand presented the draw-down claim to the Bank of America, knowing that it contained material representations of fact upon which it would rely and which Firstrand knew were untrue. Mere error, misunderstanding or oversight on the part of Firstrand, however unreasonable, would not amount to fraud [reference to *Loomcraft Fabrics CC v Nedbank Ltd*]".[360]

Therefore, the SCA confirmed the autonomous nature of standby letter of credits, and shielded the obligations assumed under it from defences originating from the underlying contract. Whether the underlying obligation for repayment had prescribed was accordingly not an issue which had to be decided for purposes of the demand under the standby letter of credit. Further comment by Swain AJA, however, must be considered. He added: "Counsel on behalf of Casey and Kimberley when asked eschewed any reliance upon fraud to challenge Firstrand's entitlement to draw-down on the letter of credit."[361]

This particular comment by the court points to an interesting fact. It is submitted, that this could potentially provide evidence that the South Africa law of demand guarantees may not be entirely oblivious to questions of prescription of underlying obligations when

[357] n 59.

[358] par 12, per Swain AJA.

[359] par 16.

[360] par 16 (omissions and insertion by me).

[361] par 16.

assessing the validity of claims under such abstract instruments. In the case of *Casey v Firstrand Bank Ltd* no such allegations of fraud were entertained at the relevant stage of litigation but, in the future, parties to such a dispute could perhaps do so successfully. This observation ties in with the considerations presented above, and the upcoming notion of fraud as positive knowledge of the lack of entitlement in South African law of demand guarantees. It must be appreciated, however, that South African law does not necessarily render extinct – simultaneously – the two different obligations (the one stemming from the underlying relationship, and the other one under the guarantee) due to prescription. Further, as was pointed out above, even if payment is made on a prescribed debt, reclaiming of payment is usually not possible. Therefore, a guarantor trying to defend a claim on the guarantee – with reference to prescription of the underlying debt – will probably fail in most situations.

English law subscribes to the notion that statutory prescription merely renders a debt unenforceable,[362] yet payment made on a prescribed debt cannot be recovered on the ground that performance was not due.[363] English courts do not seem to have dealt with the problem of prescribed underlying claims secured by demand guarantees as yet. Due to the lack of specific guidance from case law, one would have to approach the matter with reference to the fraud exception as established in English law. English law operates with the notion that a demand on a guarantee is fraudulent if the beneficiary lacks an "honest belief" in the validity of the demand or the entitlement to the requested sums.[364] Thus one could arrive at the conclusion that an underlying, time-barred claim could taint the call on the guarantee – provided the beneficiary knows about its material disentitlement and thus lacks the required "honest belief". To determine the issue of fraud it is therefore central whether the beneficiary does have an honest belief or not, which will mostly depend on the obviousness and distinctiveness of the prescription. A situation in which a claim has clearly prescribed beyond any doubt could therefore more likely motivate an English court to grant interlocutory relief based on the fraud exception. However, as was pointed out above, under English law statutory prescription renders a claim unenforceable, but does not allow the recovery of monies paid on such a prescribed debt. Accordingly, the situation is not sufficiently clear under English law.

[362] McGee *Limitation Periods* (2014) 4 par 1.010; and Redmond-Cooper *Limitation of Action* (1992) 2.

[363] Beale *Chitty on Contracts Volume I General Principles* (2012) 2014 par 28-127; and Canny *Limitation of Actions in England and Wales* (2013) 12 par 1.17.

[364] See par 5.2.3 above.

5.6 Unconscionable conduct

5.6.1 Introduction

Reprehensible conduct on the part of the beneficiary can take many forms. Such conduct, however, is often clear only after analysis of the demand-guarantee transaction as a whole (including the underlying transaction) – a fact which is manifested by the recognition of the fraud exception in the "wide sense". The logical question that emerges from the wide fraud exception is whether reprehensible conduct falling short of fraud may not also provide an exception to the independence principle. Should a dishonest or otherwise unfairly acting beneficiary be allowed to benefit unduly from the formalised, abstract nature of the obligation under a demand guarantee? Against this background the so-called "unconscionability exception" has been considered in several, and recognised in some, jurisdictions. The most prominent in this regard have been Australia,[365] as well as Singapore and Malaysia.[366]

A major problem in regard to this issue relates to what "unconscionability" actually means. It has been said to contain elements of "abuse, unfairness and dishonesty".[367] Lee argues that a possible "unconscionability exception" is derived from general notions of equity, fairness, good faith and material justice.[368] Fedotov maintains that it is "an equitable concept".[369] This is by no means precise terminology. Hence, Mugasha[370] states that "[u]nconscionability is an elusive concept to apply", and Lurie[371] that it is "a difficult concept

[365] See *Olex Focas Pty Ltd v Skodaexport Co Ltd* [1998] 3 VR 380. The Australian law developed an unconscionability exception based on "statutory defence of unconscionable conduct". See Horowitz (n 21) 145 par 6.19 *et seq*. For this purpose the Australian courts usually refer to the Trade Practices Act 51 of 1974.

[366] *GHL Pte Ltd v Unitrack Building Construction Pte Ltd* [1999] 4 SLR 604 (CA); Rodrigo (n 49) 236-237; Enonchong (n 153) 98 *et seq*; Johns and Blodgett (n 315) 311 *et seq*; Horowitz (n 21) 130 par 6.01; Bridge (n 29) 2220-2222 par 24-036; Andrews and Millett *Law of Guarantees* (2011) 667 par 16-027; Chhina "'Unconscionability' as an exception to the autonomy principle: How well is it entrenched in Singaporean jurisprudence?" 2016 *LMCLQ* 412 420 *et seq*; and Fedotov (n 105) 69 *et seq*. A comprehensive list of cases relating to the law in Singapore is provided in Loi "Two decades of restraining unconscionable calls on performance guarantees" 2011 *Singapore Academy of Law Journal (SAcLJ)* 504 507-508 (par 6).

[367] *BS Mount Sophia Pte Ltd v Join-Aim Pte Ltd* [2012] SGCA 28 (par 19, with reference to Singaporean case law).

[368] Lee "Injuncting calls on performance bonds: reconstructing unconscionability" 2003 *Singapore Academy of Law Journal (SAcLJ)* 30 34 par 9.

[369] (n 105) 60.

[370] (n 316 *2004*) 518 (n 12) (alteration by me).

[371] (n 321) 456 par iv.

to define". Regarding its relationship to fraud, Wong[372] suggests that "[w]hile fraud will almost always constitute a component of unconscionable conduct, not every unconscionable conduct will necessarily amount to fraud". In the Singaporean guarantee case of *Raymond Construction Pte Ltd v Low Yang Tong*[373] the court explained that unconscionability

> "involves unfairness, as distinct from dishonesty or fraud, or conduct of a kind so reprehensible or lacking in good faith that a court of conscience would either restrain the party or refuse to assist the party."[374]

The essential question is therefore whether unconscionability can constitute a defence, or basis for an injunction, which is separate and distinguishable from fraud.[375] Put differently: can conduct by the beneficiary that oversteps the accepted limits of what is expected of a reasonable party in business transactions, but does not meet the requirements of the fraud defence, conveniently be termed "unconscionable" and as such provide an exception to the independence principle?[376] As emerges from *dicta* and other authorities cited above, there is some support for such an exception in especially Australia and Singapore.[377] Most other jurisdictions, however, are somewhat sceptical in this regard.

The unconscionability exception, insofar as it exists, is clearly based upon fairness and justice, but this does not make it unassailable. The pivotal role of legal certainty in international commerce in general, and the demand-guarantee transaction in particular, must always be taken into account. The uncertainty as to the exact meaning of "unconscionability" is a serious problem in this respect. Proponents for the recognition of an unconscionability exception admit the absence of "discernible guidelines of a practical and principled nature"[378] and the real difficulty

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[372] "Recent developments on demand bonds and guarantees in England and Australia" 2012 *The International Construction Law Review* 51 64 (alteration by me).

[373] [1996] SGHC 136.

[374] par 5 (per Lai Kew Chai J).

[375] *BS Mount Sophia Pte Ltd v Join-Aim Pte Ltd* (n 367) par 18, with references to further case law and scholarly opinions.

[376] *BS Mount Sophia Pte Ltd v Join-Aim Pte Ltd* (n 367) par 23. See also Fedotov (n 105) 69.

[377] Note, however, the latest development in Singaporean law which permits the curtailment of the practical application of the unconscionability exception by party agreement; *CKR Contract Services Pte Ltd v Asplenium Land Pte Ltd* [2015] SGCA 24. In his instructive analysis Wooler (n 93) stated that the Singaporean Court of Appeal "has virtually neutered the unconscionability exception" (at 172) and that "it is probable that unconscionability will rarely ever again be called up to ground an injunction restraining payment on a bond" (at 180).

[378] Loi (n 366) 513 par 12 (capitalisation changed by me, italics omitted).

> "in formulating what 'unconscionability' means in this context and how a case of unconscionability is to be sufficiently proved in evidential terms to trigger interlocutory judicial intervention."[379]

In the same vein, it has been remarked that

> "the Singaporean courts have not provided enough concrete guidance on what constitutes unconscionability and commentators have similarly failed to do so in sufficient depth".[380]

More generally, but equally fitting, it was observed:

> "The more the law is framed in terms of rigid rules, the less scope there is for judicial manoeuvring in the interests of justice; the more it is framed in terms of flexible standards, the less certain will be the outcome of any particular case."[381]

Considering the significance of legal certainty for commercial transactions, especially in regard to demand guarantees, this is an important observation.

5.6.2 South African law

In South African law the general doctrinal basis for an unconscionability exception is linked to the role of good faith in contract. Good faith in South African law is a contentious issue and has received judicial comment and scholarly attention.[382] In the case of *Brisley v Drotsky*,[383] the Supreme Court of Appeal identified good faith as a fundamental principle in South African law which, however, only applies as an underlying, general and supplementary value in conjunction with other established rules and principles. In his minority judgment, Cameron JA added that "[i]n its modern guise, 'public policy' is now rooted in our Constitution and the fundamental values it enshrines".[384] Subsequently the Supreme Court of

[379] Loi (n 366) 511 (italics omitted by me).

[380] Lee (n 368) 31 par 3.

[381] Hutchison and Pretorius (n 354) 22 par 1.8.2.

[382] See Hutchison and Pretorius (n 354) 27; Brand and Brodie "Good faith in contract law" in Zimmermann, Visser and Reid *Mixed Legal Systems in Comparative Perspective* (2004) 94 116 par V ("overt discussion and debate in the South African courts"); and MacQueen "Good faith" in MacQueen and Zimmermann *European Contract Law: Scots and South African Perspectives* (2006) 43 68 who observed in regard to, *inter alia*, South Africa that "there is current, active debate about good faith in contract, along with relevant activity in legislation, the courts and legal practice". Furthermore, note the extensive list of references to scholarly work provided by Sharrock "Unfair enforcement of a contract: a step in the right direction?" 2015 *SA Merc LJ* 174 181-183.

[383] 2002 (4) 1 SCA 15 par 22 (majority judgment per Harms, Streicher and Brand JJA).

[384] par 4 of Cameron JA's judgment.

Appeal has had further opportunity to elaborate on good faith and public policy. In *Price Waterhouse Coopers Inc v National Potato Co-Operative Ltd*,[385] Southwood AJA held:

> "At common law agreements that are contrary to public policy are void and not enforceable. While public policy generally favours the utmost freedom of contract it does take into account the necessity for doing 'simple justice between man and man'. Therefore, when a court finds that an agreement is contrary to public policy it should not hesitate to say so and refuse to enforce it. However, the court should exercise this power only in cases where the impropriety of the transaction and the element of public harm are manifest. It is an important consideration that there be certainty about the validity of agreements […]."[386]

Moreover, the Constitutional Court explained in *Barkhuizen v Napier*[387] that

> "[n]otions of fairness, justice and equity, and reasonableness cannot be separated from public policy. Public policy takes into account the necessity to do simple justice between individuals. Public policy is informed by the concept of ubuntu."[388]

This legal interpretation was supported by *dicta* from the same court in *Everfresh Market Virginia (Pty) Ltd v Shoprite Checkers (Pty) Ltd*[389] where, writing for the majority, Moseneke DCJ argued:

> "Indeed, it is highly desirable and in fact necessary to infuse the law of contract with constitutional values, including values of ubuntu, which inspire much of our constitutional compact. On a number of occasions in the past this Court has had regard to the meaning and content of the concept of ubuntu. It emphasises the communal nature of society and 'carries in it the ideas of humaneness, social justice and fairness' and envelopes 'the key values of group solidarity, compassion, respect, human dignity, conformity to basic norms and collective unity'."[390]

In his minority judgment, Yacoob J stated:

> "Good faith is a matter of considerable importance in our contract law and the extent to which our courts enforce the good faith requirement in contract law is a matter of considerable public and constitutional importance. The question whether the spirit, purport and objects of the Constitution require courts to encourage good faith in contractual dealings and whether our Constitution insists that good faith requirements are enforceable should be determined sooner rather than later. […] The values

[385] [2004] 3 All SA 20 (SCA).

[386] par 23 (omission by me).

[387] 2007 (5) SA 323 (CC).

[388] par 51 (per Ngcobo J – alteration by me, footnote omitted). *Ubuntu* is a (Southern) African societal concept which embraces solidarity, humanness, interconnectedness, mutual respect and compassion, among others. See *The Citizen 1978 (Pty) Ltd v McBride* 2011 (4) SA 191 (CC) par 216 *et seq*; *Dikoko v Mokhatla* 2006 (6) SA 235 (CC) par 66 *et seq*; Malan "The suitability and unsuitability of Ubuntu in constitutional law – inter-communal relations versus public office-bearing" 2014 *De Jure* 231 231-232; Brand, Steadman and Todd *Commercial Mediation* (2012) 1-2; Twomey "Legal salmon: comparative law and its role in Africa" in Mancuso and Fombad *Comparative Law in Africa: Methodologies and Concepts* (2015) 85 96; and Bennett "Ubuntu: an African equity" 2011 *Potchefstroom Electronic Law Journal* 351 351-352 (note also his remarks relating to the difficulties of translating the term ubuntu).

[389] 2012 (1) SA 256 (CC).

[390] par 71 (footnotes omitted).

> embraced by an appropriate appreciation of ubuntu are also relevant in the process of determining the spirit, purport and objects of the Constitution."[391]

The Constitutional Court continued to elaborate on good faith and public policy in *Botha v Rich*,[392] where Nkabinde J held:

> "Public policy requires that parties should in general comply with contractual obligations that have been freely and voluntarily undertaken. [fn 38: This consideration, expressed in the maxim *pacta sunt servanda*, gives effect to the central constitutional values of freedom and dignity.] […] All law, including the common law of contract, derives its force from the Constitution and is thus subject to constitutional control."[393]

Moreover, she stated that:

> "our law of contract, based as it is on the principle of good faith, [fn 64: It has often been asserted by the courts that in our law all contracts are subject to good faith. Taken at face value that means that the requirement of good faith underlies and informs the South African law of contract […].] contains the necessary flexibility to ensure fairness."[394]

Commentators have therefore concluded, that the

> "the main principle that is applied in South African law with respect to the content, execution and enforcement of contracts is that the agreement must not offend against public policy or the public interest. However, good faith, being an underlying value, may very well influence the content of public policy."[395]

Additionally, Hutchison and Pretorius identify "good faith" as one of several "fundamental ideas"[396] in modern law of contract and observed:

> "The concept of good faith, or *bona fides*, has deep roots in our legal system. […] In recent times, there has been much debate about the role it might play in the modern law of contract, as a counterweight to the dominant idea of freedom of contract, and as a means of developing a doctrine of unconscionability to ensure greater fairness in contractual relations."[397]

The scholars Siliquini-Cinelli and Hutchison[398] stressed the importance of the South African Constitution for the legal development in this regard and argue:

> "Whether the Constitutional Court will develop the South African doctrine of 'fairness' into something akin to the open norm of good faith, whether as capable of founding a cause of action independently, or as a term implied by law in all contracts, remains to be seen. […] What we can assert with confidence

[391] par 22-23 (omission by me).

[392] 2014 (4) SA 124 (CC).

[393] par 23-24 (omission and integration of footnote 38 into the quote by me).

[394] par 45 (omission and integration of footnote 64 into the quote by me).

[395] Van Huyssteen and Maxwell (n 354) 70 par 101.

[396] Hutchison and Pretorius (n 354) 21 par 1.8.

[397] Hutchison and Pretorius (n 354) 26-27 par 1.8.4 (omission by me).

[398] "Constitutionalism, good faith and the doctrine of specific performance: rights, duties and equitable discretion" 2016 *SALJ* 73 84 (omission by me).

> at this stage, however, is that the Constitution is relevant at all stages of contracting, from negotiation to conclusion to performance and, if necessary, enforcement."

What emerges clearly from the *dicta* and legal commentary is the fact that good faith and the related problem of unconscionability are much-discussed and important legal issues in South African contract law. The impact which the Constitution has had, and continues to have, is evident.

Turning specifically to unconscionable demands under independent guarantees, however, more interesting *dicta* have emerged from South African courts in recent times. In *Sulzer Pumps Limited v Covec-MC Joint Venture*,[399] Jansen J made the following, remarkable suggestion:

> "[N]ot only fraud may prohibit the calling up of a construction guarantee, but also unconscionable conduct and also when a contract to the contrary has been entered into between the relevant parties (in this instance, including the bank)."[400]

Unfortunately, Jansen J did not elaborate convincingly or sufficiently as to why this should reflect the current position in South African law. It is submitted that her brief reference to the "old authorities"[401] provides no persuasive support for her statement at all. In a similar fashion, Satchwell J, in *Group Five Construction (Pty) Limited v Member of the Executive Council for Public Transport Roads and Works Gauteng*, remarked that

> "[a]bsence of good faith as ground for declining enforcement of a guarantee has received support from the Supreme Court of Appeal in the minority judgement of Cloete JA in [*Dormell Properties*] as also in [*Guardrisk v Kentz*], [*Scatec Solar*] and *Cargill International SA v Bangladesh Sugar and Food Industries Corp* [1996] 4 All ER 563 (QBD)."[402]

[399] [2014] ZAGPPHC 695 (2 September 2014).

[400] par 115 (omission, added emphasis and alteration by me).

[401] For example in par 113 Jansen J quotes at length from Voet and Paulus as follows: "It is quite true that in all obligations to which no time has been attached the debt is presently due. None the less, we oueht [sic] not on that account to take the view that humane feeline [sic] and also judicial discretion have been barred out. The result is that when a borrower is sued a moderate period of grace to suit the changing character of the transaction is vouchsafed either by the lender or by the judge. It follows that you would rightly apply to this case the famous saying of Paulus – 'Though law fails me, equity prompts such a conclusion.'" (emphasis by Jansen J, insertions by me). Voet's elaborations, however, concern the repayment of a loan, and the date for repayment if the parties failed to assign a due date in their contract. His explanations do not offer the least support at all for Jansen J's statement that unconscionable conduct may form an exception to the principle of independence in South African law. Also, Paulus is quoted by Voet, and in turn by Jansen J. Also Paulus' statement can hardly be seen as convincing authority for the unconscionability exception in demand guarantees – it makes a mere reference to equity in regard to the due date for repayment of a loan.

[402] *Group Five Construction (Pty) Limited v Member of the Executive Council for Public Transport Roads and Works Gauteng* (n 79) par 50 (alterations by me). See Kelly-Louw and Marxen (n 79) 294-295 for a case discussion. Similarly, Mashile J also suggested in *Hollard Insurance Co Ltd v Jeany Industrial Holdings (Pty) Ltd* [2016] ZAGPJHC 175 (24 June 2016) that a demand made "fraudulently or in bad faith" (par 28),

Although Satchwell J referred to the "absence of good faith", and not to unconscionable behaviour or unconscionability, these concepts, as pointed out above, potentially mean very much the same thing. Her reference to the four cases – in order to show support for the contention that bad faith may constitute a basis for judicial relief in demand guarantees – is not convincing. While the cited judgments indeed include *dicta* which *mention* bad/good faith, they can hardly be seen as adequate authority that bad/good faith may constitute a (separate) exception to the principle of independence in South African law. For example, Cloete JA's judgment, which she also referred to, could probably even be authority for a view to the contrary.[403] Finally, as regards the South African law in this respect, it should be pointed out that the current available commentary is not in favour of recognising a separate unconscionability exception.[404]

5.6.3 English law

In respect of unconscionable conduct, it seems that in English law the situation is akin to the traditional view in South Africa. Fraud remains the legal centre piece by which unjust demands on independent guarantees can be dealt with. The closest advance English law made towards recognising the unconscionability defence is to be found in *TTI Team Telecom International Ltd v Hutchison 3G UK Ltd*.[405] In that case Thornton J ruled that:

> "Only if the issuer is about to make payment to the beneficiary in circumstances where fraud, *dishonesty* or *bad faith* in relation to the demand is shown to exist […] will a court intervene to restrain payment by the issuer to a beneficiary."[406]

> "A lack of good faith has for a long time provided a basis to restrain a beneficiary from calling a bond or guarantee."[407]

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without elaborating at all on what bad faith may entail, could potentially give rise to interference with the payment of a demand guarantee.

[403] See, for instance, Cloete JA's remarks at 63 ("Put more accurately, a valid demand on the construction guarantee can only be defeated by proof of fraud") in *Dormell Properties*. The fact that his judgment *mentions* good/bad faith in par 65 does not necessarily support Stachwell J's reasoning, due to the specific context in which Cloete JA's observation was made.

[404] Kelly-Louw and Marxen (n 79) 293; and probably also Hugo (n 278) 452. See also Enonchong (n 153) 103 *et seq*; and Dolan "Bad faith and unconscionability" 2012 *DCInsight* September.

[405] n 27.

[406] par 31 (added emphasis and omission by me).

[407] par 34.

Similar terminology referring to "good faith" was used again in *HLC Engenharia e Gestao de Projectos SA v ABN AMRO Bank NV*.[408] Generally, however, it remains unclear what unconscionability could mean and encompass in relation to letters of credit and demand guarantees. Horowitz is highly critical of these *dicta*.[409] With the support of other commentators she concludes, convincingly, that English law does probably not recognise a general unconscionability exception.[410] Her main concerns are the need to investigate the underlying relationship thoroughly in order to ascertain potential unconscionability, and with it the undermining of the principle of independence; this leads her to reject the notion of unconscionability as a ground for infringing on the autonomy principle in English law. Moreover, she points out that scenarios which may lend themselves to defences based on unconscionability can conceivably also be dealt with the wider fraud exception. Additionally, she stresses the fact that most English cases which investigated unconscionability, and which have been cited by commentators in order examine whether there could be an unconscionability exception in English law, did so by contemplating restraining the *beneficiary* from calling up the demand guarantee, and not the *guarantor* from honouring a call. This important difference can also be used to suggest that in any event the unconscionability arguments raised thus far in English case law are not concerned with an actual exception to independence, but involve the relationship between the parties of the underlying transaction and border on the negative stipulation issue discussed below.[411]

At the moment, English law does not seem to accept an unconscionability exception, despite the occasional references by courts in certain *dicta* to good/bad faith or dishonesty when discussing the availability of judicial interventions in letter-of-credit and demand-guarantee transactions. This observation finds support, for example, in the recent *National Infrastructure Development Co Ltd v Banco Santander SA* case,[412] where Knowles J explained:

> "The third main point taken by the defendant is that the law should develop to recognise a different approach to standby letters of credit used to settle performance obligations from the approach to letters of credit used to settle primary payment obligations. It is argued that such a development in the law is

[408] [2005] EWHC 2074 (TCC) par 33.

[409] See the comprehensive analysis in Horowitz (n 21) 129-171.

[410] Horowitz (n 21) 129-130 par 6.01 and 169-171 par 6.52-6.53; Enonchong (n 15) 161 par 7.06; and Enonchong (n 153) 101. But note also Johns and Blodgett (n 315) 327-328.

[411] See chapter 7 below.

[412] n 33.

> especially suited to the construction industry context and where parties to the contract in dispute were already in arbitration. The effect would, it is suggested, be to admit an exception for unconscionable conduct alongside the existing, recognised, fraud exception. […] Academic materials do debate the point that lies behind the defendant's contention, but ultimately what weighs with me particularly heavily is that this is a context in which if I postpone I positively undermine the element of time that was an important part of this type of transaction."[413]

Given the noticeable lack of clear guidelines and consensus regarding the scope of such a potential exception based on unconscionability, and because of the importance of legal certainty, the fraud exception remains the centrepiece in English law for engaging abusive conduct by a beneficiary.

5.6.4 German law

In Germany, the doctrine of *Rechtsmissbrauch* is able to prevent abusive conduct by a beneficiary when it submits a formally compliant demand while lacking material entitlement.[414] Based on the notion of good faith and fair dealings and the respective provisions in the German Civil Code,[415] this concept aims at prohibiting grossly unfair demands which seek to exploit the formalised payment mechanisms of letters of credit and autonomous guarantees. Since the *Rechtsmissbrauch* exception was not particularly built upon fraud but, in fact, on good faith ("Treu und Glauben"), it was already broader and more flexible from its inception. It is probably reasonable to argue against any further expansion of the defence, and thus additional inroads into the principle of independence: first of all, German law never clung to the falsification of documents as the only grounds for interdicting calls on abstract payment instruments and therefore has always been cognisant of the transaction as a whole to identify cases in which judicial intervention was permissible. Secondly, to implement an "unconscionability exception" would pose serious challenges from a technical, conceptual point of view. German law is based on the understanding that only *Rechtsmissbrauch* may defeat the principle of independence. With its comparatively wide scope in application, yet its strict focus on the divergence of formal and material entitlement to invoke an exception to the independence principle, it would not easily allow for the introduction of exceptions which "function" differently. Introducing an

[413] par 26-27 (omission by me).

[414] For an in-depth discussion of the doctrine of *Rechtsmissbrauch* in German law see par 5.2.9 above.

[415] See par 5.2.9 above.

unconscionability exception, which would be – technically speaking – possible under South African or English law, is simply not conceptionally feasible under German law; an unconscionability exception would require to discard the German idea of divergence of formal and material entitlement, and devise a new legal mechanism, parallel to the *Rechtsmissbrauch* exception, under which unconscionable conduct – whatever that may be – could be captured. Third, it could already be seen as *unconscionable* to insist on enforcing a formal right in the absence of material entitlement. Unconscionable conduct and other seriously unfair conduct, which meets the *Rechtsmissbrauch* criteria, are in many cases fairly similar. Actually, "unconscionability" is a very fitting and proper single word to translate and embrace the German term and concept of "Rechtsmissbrauch" (which is usually translated as the "abuse of rights"). The potential overlap in scope and application is evident, and it is neither necessary nor beneficial to accept an additional exception to the principle of independence in German law.

5.6.5 Conclusion

Despite the fact that both English and South African law contain elements of a possible unconscionability exception in certain *dicta* of the courts, it would be proper to say that it has not yet been accepted in either jurisdiction. The similarity and congruity of the fraud exception, based on "no honest belief" (in English law) or "knowledge of lack of entitlement" (in South African law), and the unconscionability exception is clearly discernible: "In the context of performance guarantees it [unconscionability] simply means lack of bona fides on the part of the beneficiary calling under the guarantee."[416] A strong case can be made out to the effect that the modern fraud rule is wide and flexible enough to include most unconscionable conduct by the beneficiary. Hence, there is little need for the recognition of a separate unconscionability exception especially if one bears in mind the detrimental effect it is likely to have in regard to legal certainty.

The same can be said in regard to German law: the traditional concept of *Rechtsmissbrauch* is flexible and far-reaching, and would probably overlap in many instances with that of an unconscionability exception. Accordingly, German law does not seem to

[416] Quote taken from Rodrigo "The principle of good faith in the enforcement of performance guarantees" 2014 *Singapore Academy of Law Journal (SAcLJ)* 280 283 par 6 (italics omitted, insertions by me).

necessitate the introduction of a separate exception. Furthermore, due to the strong focus in German law on the established *Rechtsmissbrauch* doctrine, any attempts of introducing a new and distinct exception solely based on unconscionability would pose serious technical challenges.

In light of the above, it is suggested that a separate unconscionability exception is not at the moment, and is not likely in future to be, part of the law in South Africa, England or Germany. The existing concepts of fraud and *Rechtsmissbrauch* are probably sufficient to deal with unconscionable conduct, while maintaining legal certainty and thus preserving the merits of demand guarantees. Johns and Blodgett[417] voiced concern in regard to the rise of the unconscionability exception in certain jurisdictions which is, it is submitted, absolutely in point:

> "As these exceptions evolve and spread, one would hope the debate between fairness and certainty will favour certainty. Otherwise, the independence principle will eventually become the *inter*dependence principle".

The legal development and changes in (public) policy relating to demand guarantees in recent years, however, warrant caution when making predictions regarding potential further exceptions.

5.7 Gross disproportionality between actual damages suffered and the amount demanded under the guarantee

The question scrutinised in this paragraph is whether the fact that the amount claimed under a guarantee is grossly disproportionate to the amount of damages suffered by the beneficiary, can be the basis for a defence or injunction. In order to assess this issue, one must again be mindful of the fact that demand guarantees are independent of the underlying claims. Ellinger and Neo explain that "[b]anks issuing independent guarantees usually undertake to pay upon the presentment of conforming documents by the beneficiary, […] but do not require proof of the applicant's default".[418] Therefore, proof of default, and, concomitantly, the extent thereof (which relates to the extent of damages) should be unnecessary provided the demand is otherwise formally conforming.[419] Hence, both the JBCC and the GCC pro-forma guarantees

[417] (n 315) 337 (italics in the original).

[418] Ellinger and Neo (n 49) 310 par B (alterations and omission by me).

[419] See also Lehtinen (n 88) 514.

require a statement by the beneficiary alleging breach of contract by the applicant, but nothing relating to the extent of losses suffered as a consequence – let alone proof thereof. Kelly-Louw describes it best:

> "When a compliant demand is made the guarantor must, in principle, pay irrespective of whether the underlying contract has, in fact, been breached and *irrespective of the loss actually suffered by the beneficiary*."[420]

All of the aforementioned considerations support the conclusion that the question posed above should be answered in the negative.

The position, however, is not that simple. There is support in German law[421] for the notion that under certain circumstances a claim, which clearly exceeds the actual damages suffered excessively, would be abusive.[422] In 1980 the *Landgericht Dortmund*[423] held that a demand under an abstract performance guarantee was abusive and allowed an interdict prohibiting payment where a beneficiary had claimed the full amount of approximately 80.000 Deutschmarks under the guarantee despite the fact that the only damage possibly sustained would have amounted to a mere 650 Deutschmarks.[424] Due to the "eklatantes Mißverhältnis"[425] the court condemned the beneficiary's conduct and refused to lift the interim order issued previously. [426] The theoretical basis of this type of case must be sought within the doctrine of *Rechtsmissbrauch*,[427] giving the applicant the right to approach the courts in cases in which the beneficiary abuses its formal position under the demand guarantee despite the obvious and undisputable absence of material entitlement under the construction contract. Mülbert[428] is highly critical of this case. He argues that the utilisation

[420] (n 58 *2014*) 214 (her emphasis).

[421] LG Dortmund 1981 *WM* 280. Although concerning a different commercial context, the legal principles are equally applicable to a construction context.

[422] Note also the explanation in Graf von Westphalen and Zöchling-Jud (n 90) 210 par 215; and Schütze and Edelmann (n 283) 93 par 2.2.

[423] Regional Court Dortmund.

[424] LG Dortmund (n 421). Converted into Euros, this would be approximately 40.000 Euros, and 325 Euros, respectively.

[425] LG Dortmund (n 421) 283. "Eklatantes Mißverhältnis" can be translated as "blatantly disproportionate".

[426] LG Dortmund (n 421) 282 ("Die einstweilige Verfügung vom 17. Januar 1980 hat sich auch nach mündlicher Verhandlung als gerechtfertigt erwiesen"). Incidentally, the court also based its decision on another fact which related to the identity of the parties to the different transactions, see par 6.3.4.1 below.

[427] See par 5.2.9 above.

[428] (n 132) 79 par G. See also Lohmann (n 125) 109. On the other hand, regard may be had to remarks of Graf von Westphalen and Zöchling-Jud (n 90) 210 par 215.

of an abstract guarantee implies the expectations of all parties that the guaranteed, maximum amount serves as a means to predict the possible damages expected, almost akin to a liquidated-damages clause. If the applicant at a later stage, by way of invoking the *Rechtsmissbrauch* defence, could undermine the pre-determination of potential damages then, according to Mülbert, the contractual allocation of risks would be disturbed. Also, the *BGH* has expressed its reluctance to interfere in the payment process of demand guarantees on the basis that the amount claimed under the guarantee does not correspond to the actual entitlement with regard to the underlying relationship.[429] It held that judicial intervention will most likely be refused, if general payment on the guarantee cannot be disputed convincingly by the applicant, but only the particular amount, and that this point should rather be argued at a later stage of final accounting between the applicant and beneficiary.[430]

The English courts, as a rule, are less inclined to interfere with the independence principle. In *Cargill International SA v Bangladesh Sugar and Food Industries Corp*,[431] the Court of Appeal allowed the call on an independent performance guarantee despite the applicant's objection that no damages were suffered by the beneficiary. However, the court pointed out that allowing the call under the guarantee to proceed may lead to commercial hardship due to the absence of actual damages on the part of the beneficiary, and therefore proposed (per Potter LJ):

> "In these circumstances the obligation to account later to the seller [the applicant], in respect of what turns out to be an overpayment, is a necessary corrective if a balance of commercial fairness is to be maintained between the parties."[432]

Moreover, Staughton LJ added:

> "The general situation as to performance bonds is that they provide that the bank or other party giving the bond has to pay forthwith, usually on demand. But subsequently there has to be an accounting between the parties to the commercial contract."[433]

[429] Note also BGH 1994 *WM* 106. Although the instrument under consideration was a so-called "Bürgschaft auf erstes Anfordern" (see par 4.5.2 above), the case is relevant.

[430] The court held at 107: "Zu Unrecht meint das Berufungsgericht, dem offensichtlichen Fehlen des materiellen Anspruchs gegen den Hauptschuldner sei der Fall gleichzuachten, daß der Gläubiger Bestand und/oder Umfang eines derartigen Anspruchs nicht schlüssig darlege. […] Ist aber der Bürgschaftsfall als solcher gewiß und nur die Höhe der Bürgenhaftung im Streit, kann dem Bürgen, der sich zur Zahlung auf erstes Anfordern verpflichtet hat, um so eher zugemutet werden, den Streit in einem Rückforderungsprozeß auszutragen." – omission by me.

[431] [1998] 1 WLR 461.

[432] 469 (insertion by me).

[433] 471.

Certain notions emerge from this English case: it is obvious that claims for excessive demands on abstract guarantees occur and generally succeed due to the independent nature of the instruments and the English reluctance to intervene in such commercial transactions. The *Cargill* case, however, suggests that English law may favour a *two-tiered approach*. The *first step* comprises the court's observation that demand guarantees are abstract promises by the guarantor to pay upon conforming documents; once documents are tendered which comply with the terms of the guarantee, immediate payment can be expected. Only at a *second stage* will the English law accommodate concerns relating to material justice, an undertaking which Potter LJ described as a "necessary corrective": there must be a subsequent accounting between the parties to the commercial contract, establishing the actual loss suffered and moneys recoverable or payable. "This rule" as Davis puts it, "mitigates to some extent the potentially harsh consequences of providing a demand guarantee".[434] The obligation of a final accounting exercise effectively transfers the risk of insolvency and litigation to the applicant – a solution firmly in line with a major commercial function of demand guarantees, namely to ensure fast and reliable access to money to which the beneficiary regards itself as being entitled.[435]

However, the current English approach of regarding fraud in the demand guarantee context as the absence of an "honest belief" may impact upon the two-tiered approach as set out above. Although the "duty to account"[436] remains an integral part of English law in this regard, it is submitted that English law may indeed, in a fitting case, deem a grossly disproportionate demand as fraudulent. This, in any event, is the view set out in the authoritative text book *Benjamin's Sale of Goods*: "In the context of an autonomous guarantee, *fraud* connotes the *absence of an honest belief* in either the entitlement to claim under the guarantee or in the *amount* claimed."[437]

Thus, should the applicant convince the court that the beneficiary cannot honestly believe itself entitled to the amount claimed under the guarantee, it may very well succeed in enjoining payment. Should the applicant fail, and it were to become evident during a final accounting exercise that the amount claimed was not due, the applicant would of course be

[434] (n 105) 10 par 2.42.

[435] See the discussion in par 3.3 and 3.4.2 *et seq* above.

[436] Davis (n 105) 10 par 2.42.

[437] Bridge (n 29) 2211 par 24-023 (emphasis is mine).

entitled to repayment in accordance with the principles set out in the *Cargill* case. This is a clear subscription to the notion of "pay first, argue later".[438]

Grossly disproportionate demands have not featured as yet in South African law. It is submitted, however, that the issue must be simply dealt with in accordance with the principles of the fraud exception, in a similar fashion as discussed above in relation to English law. In *Guardrisk v Kentz*[439] Theron JA stated:

> "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."[440]

Therefore, the entitlement to payment referred to in this *dictum* can, it is suggested, conceivably relates also to an entitlement to a *specific amount*. There is no sound argument to restrict the rule in *Guardrisk v Kentz* to apply only to cases in which the call on the guarantee is without basis in its entirety – it must be sufficient if the knowledge of the lack of material entitlement on the part of the beneficiary relates "only" to the inflated amount.

Thus, in conclusion it would appear that South African and English law, in accordance with the fraud exception, may conceivably in clear and compelling cases allow injunctive relief to an applicant where a beneficiary's demand is grossly disproportionate to the damage suffered. No such claim however has succeeded as yet in either jurisdiction. German law, on the other hand, despite one case which found to the contrary, seems to be more reluctant and usually denies judicial intervention is such cases. Parties are most likely referred to establish the (dis)entitlement to the monies at a later stage of final accounting (*Rückforderungsprozess*, and "pay first, argue later").[441]

In any event it is clear that in none of the jurisdictions, and with good reasons (of which the final accounting exercise is part), will relief be granted lightly in cases of alleged disproportionality. This is a consequence of the high regard in the legal systems under scrutiny for the independence principle in demand guarantees.

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[438] See par 3.4.2.4 above.

[439] n 73.

[440] par 17 (emphasis is mine).

[441] See par 3.4.2.4 above.

5.8 Doctrine of merger (*confusio*)

Complex construction projects may require wide-ranging construction expertise and knowledge, sufficient working capital, a well-developed infrastructure and specific machinery. In order to meet these requirements construction companies often form joint ventures, in the form of partnerships or companies, to compete for construction tenders.[442] These agreements can be very detailed and include provisions relating to the individual responsibility of the involved partners or shareholders, and clauses dealing with the joint venture's organisation in response to changes within its structure. Against this background a recent case in Germany explored the legal effect the doctrine of merger applied in a demand-guarantee context.

The doctrine of *confusio* or merger applies when a person or entity becomes both debtor and creditor of an obligation concurrently.[443] This is a rare event, and mostly occurs when a debtor becomes heir to the creditor (or vice versa), or when a lessee acquires ownership of the rented property.[444] In these instances, the obligation will be extinguished by operation of the doctrine of merger.[445]

In a case before the *Oberlandesgericht Munich*,[446] the court was called upon to decide whether a claim could be filed (as part of the list of creditors) against the liquidator of an insolvent company (identified as ODS). The relationships between the different parties involved were fairly complex. Simplified[447] for the purpose of the issue under consideration they can be stated as follows: the claimant and the now insolvent company ODS founded a

[442] Uff (n 203) 141; Klee *International Construction Contract Law* (2015) 19-20 par 1.15.2 and 21-22 par 1.15.4; Beale (n 207) 717 par 37-017; Bertrams (n 7) 497 par 19-3; and Bailey (n 226) 94 par 2.126.

[443] Christie and Bradfield (n 354) 499-500; Beale (n 207) 1738 par 25-004; Scott and Cornelius *The Law of Commerce in South Africa* (2014) 110 par 7.5; Hutchison and Pretorius (n 354) 383 par 15.4.2; Bamberger and Roth *Kommentar zum Bürgerlichen Gesetzbuch Band 1* (2012) 1814 paragraph 362 par 7; and Gursky and Olzen *J von Staudingers Kommentar zum Bürgerlichen Gesetzbuch Buch 2 362-396 (Erfüllung, Hinterlegung, Aufrechnung)* (2011) 10-12 Intro paragraph 362 par 25-26.

[444] See Beale (n 207) 1738 par 25-004; Du Bois (n 354) 831 par 2; and the examples in Scott and Cornelius (n 443) 110 par 7.5; and Hutchison and Pretorius (n 354) 383 par 15.4.2.

[445] Van der Merwe, van Huyssteen, Reinecke and Lubbe *Contract General Principles* (2012) 439-440 par 13.1; Hutchison and Pretorius (n 354) 383 par 15.4.2; Du Bois (n 354) 831 par 2; Bamberger and Roth (n 443) 1814 paragraph 362 par 7; as well as Gursky and Olzen (n 443) 12 Intro paragraph 362 par 28.

[446] OLG Munich (n 145). For certain aspects of this case see also the discussion in Kelly-Louw and Marxen (n 79) 295-300.

[447] The omitted issues relate – *inter alia* – to undercapitalisation provisions and security priority under German company and insolvency law, and the alleged partnership of a company identified as CoFonds B,- und V.GmbH (see par 5, 8, 12, 15, 31-38 of the judgment).

limited partnership[448] trading under the name HLS L&S GmbH & Co KG (HLS) in 2006.[449] The articles of association, however, assigned different responsibilities and legal obligations to the two partners. The claimant's liability was limited to its prescribed capital investment[450] while ODS accepted unlimited liability for debts and obligations incurred by HLS.[451]

The claimant's initial investment capital in HLS amounted to 15 million Euros which was duly deposited. In German law this meant that no further financial obligations or liabilities in relation to the partnership were assumed by the claimant.[452] As compensation for its considerable financial involvement it was to receive a pay-out of almost 250.000 Euros per month from HLS.[453] To secure this recurring payment obligation, ODS issued a demand guarantee on application of HLS in favour of the claimant. It was payable on demand within five bank working days in the event of the original debtor, HLS, failing to meet a monthly payment.[454] When HLS failed to make payment over a longer period, the claimant decided to call up the guarantee against ODS. In the meantime ODS, however, had gone into bankruptcy. The articles of association, under which HLS was initially founded, provided that as soon as bankruptcy proceedings were commenced against any partner it would be considered expelled from HLS, and, should only one partner remain due to the expulsion provision, it would assume all assets and outstanding obligations of HLS.[455] Since ODS was placed under administration due to insolvency and therefore expelled as a partner of HLS, the claimant remained as the sole partner and assumed all rights and liabilities of HLS. As a consequence, the claimant remained creditor of the claim for monthly payment, but also became the debtor of this very obligation. Moreover, the claimant, who was the beneficiary of the guarantee, now also assumed the position of the applicant for the guarantee.

[448] In German law, this is known as a *Kommanditgesellschaft*. See paragraphs 161 *et seq* HGB (*Handelsgesetzbuch*, the German Commercial Code). It requires at least two partners, one acting as "general partner" (assuming unlimited liability, the so-called *Komplementär*), and the other as "limited partner" (with limited liability, the so-called *Kommanditist*). The fact that in the present case the *Komplementär* was a so-called *GmbH* (limited company) is irrelevant for purposes of this discussion and left unaddressed.

[449] par 2 of the judgment.

[450] So-called *Einlage*.

[451] Therefore, in German law the claimant is known as a *Kommanditist* and ODS as a *Komplementär*.

[452] Paragraph 171 (1) HGB.

[453] par 3.

[454] par 3.

[455] The articles of partnership declared that "Verbleibt nur noch ein Gesellschafter, so geht das Vermögen der Gesellschaft ohne Liquidation mit Aktiva und Passiva und dem Recht, die Firma fortzuführen, auf diesen über"; see par 7 of the judgment.

Subsequently, the claimant wished to file its claim under the guarantee in the liquidation of ODS.

The court rejected this application and refused any claims by the claimant with reference to the doctrine of *Rechtsmissbrauch*.[456] It was held that by virtue of *confusio* the underlying monthly claim had been extinguished (the debtor and creditor having become the same person).[457] Likewise, the court held that the claimant, in addition to being the beneficiary of the guarantee, had also become the applicant thereof.[458] Hence, should the claimant pursue its demand under the guarantee (or its filing as part of the list of creditors), it would, as applicant of the guarantee (in accordance with the contract of mandate),[459] in any event have to reimburse the guarantor for any payment in terms of the guarantee.[460] Therefore, a demand for payment under the guarantee would amount to *Rechtsmissbrauch*.[461]

Emphasising the extraordinary facts of this particular case,[462] the *Oberlandesgericht Munich* accordingly overturned an earlier order,[463] and essentially refused to give effect to the principle of independence. With regard to the German doctrine of *Rechtsmissbrauch*, and the

[456] par 25.

[457] par 27 ("Dies beruht insbesondere darauf, dass die Klägerin Rechtsnachfolgerin der HLS wurde und damit Konfusion eintrat, so dass sie zugleich Gläubigerin und Schuldnerin der gesicherten Forderung wurde") and 39 ("Damit ist mit Rechtskraft des Beschlusses über die Eröffnung des Insolvenzverfahrens über das Vermögen der Gemeinschuldnerin diese aus der Gesellschaft ausgeschieden, § 15 Abs. 2 des Gesellschaftsvertrags, und ist, da zu diesem Zeitpunkt nur noch ein Gesellschafter, die Klägerin, verblieb, das Vermögen der Gesellschaft mit allen Aktiva und Passiva und dem Recht, die Firma fortzuführen, auf diesen übergegangen. Damit fiel zu diesem Zeitpunkt im Hinblick auf die streitgegenständliche, der Garantie unterliegende, Forderung auf Zahlung eines Vorabgewinns Schuldner- und Gläubigerstellung zusammen und ist bei der Klägerin Konfusion eingetreten.").

[458] The court explained in par 27: "Daneben ist sie auch Garantieauftraggeberin gegenüber der Garantin, der Gemeinschuldnerin, geworden. Das hat zur Folge, dass das Valutaverhältnis, das Deckungsverhältnis und das Garantieverhältnis nunmehr allein zwischen den Streitparteien bestehen".

[459] See par 3.3 above.

[460] "Die Klägerin wäre als Rechtsnachfolgerin der HLS dem Befreiungs- Aufwendungs- und Rückgriffsanspruch der Gemeinschuldnerin zur Rückerstattung verpflichtet" (par 39).

[461] par 27, 37 and 39.

[462] Note par 27 ("Aufgrund der besonderen Umstände im vorliegenden Fall") and par 28 ("Diese besondere formale Rechtsstellung der Klägerin rechtfertigt es vorliegend").

[463] OLG Munich (n 145), and also the court of first instance LG Munich 12 HKO 3228/08 (15.12.2011) (unreported judgment).

principles of the maxim *dolo facit, qui petit, quod statim redditurus est* also referred to,[464] it is suggested that the decision is well-reasoned and correct.

Neither South African nor English law has to the best of my knowledge been confronted by a similar case. Disputes relating to merger and *confusio* have, to date, been concerned with different aspects in the context of contract, business and property law.[465] Therefore, it is not certain how South African or English law would decide a case with a set of facts akin to those considered by the *Oberlandesgericht Munich*. The principle that the applicant must compensate the guarantor for payments made under the guarantee is, of course, firmly established.[466] Its application in this situation, however, is less so. On the one hand, it can be argued that the beneficiary must not be permitted to demand and accept cash which it will have to return immediately due to reimbursement obligations. This solution could find support in Bertelsmann AJA's elaboration in *Dormell Properties*:

> "It would amount to an *academic exercise* without practical effect if Dormell were to be granted the order it seeks. It would immediately have to repay the full amount to Renasa or Synthesis. *Such an order would, at best, cause additional cost and inconvenience to the parties, without any practical effect.*"[467]

Although the *Dormell Properties* case concerned a different situation than in the merger/*confusio* scenario,[468] one could argue that there is a narrow link between the two legal matters. If this notion is taken seriously, it can support the idea that cash should not be moved back and forth if it is reasonably clear from the outset that it has to be returned eventually.

On the other hand, "the issue of whether to allow cash to exchange hands, albeit temporarily, [could] be determined with different results, based on notions of public policy."[469] Honouring the call on the guarantee would only lead to a temporary allocation of the money which, subsequently, can be rectified and reversed through litigation.[470] Forcing the guarantor to accommodate the demand for payment and then claim reimbursement from

[464] See the earlier court order OLG Munich 7 U 313/12 (05.07.2012) (juris) at par 11 ("Letzteres führt damit auch dazu, dass der Beklagte mit seinem Einwand der unzulässigen Rechtsausübung (dolo facit, qui petit, quod statim redditurus est) nicht durchdringen kann") – which was overturned by OLG Munich (n 145).

[465] For example *Grootschwaing Salt Works Ltd v Van Tonder* 1920 AD 492; and *Total Oil Products Ltd v Perfect* 1964 (2) SA 297 (D).

[466] See par 3.3 above.

[467] par 45 (my emphasis).

[468] See par 5.3.2 above.

[469] Kelly-Louw and Marxen (n 79) 300 (alteration by me).

[470] As I have argued in Marxen (n 155) 145 par III.1.

the applicant, who in turn must seek the return of the money from the beneficiary, appears to be complicated. This process, however, is entirely in line with the independence principle ("pay first, argue later")[471] and the general allocation of risks[472] intrinsically linked to the utilisation of demand guarantees: the risk on the applicant of having to litigate to enforce repayment of proceeds of a guarantee which were claimed without justification, and the risk of insolvency of the debtor (the beneficiary) when collecting.

It is therefore uncertain how this policy issue will be determined under English and South African law. In light of the above it is suggested that, generally, preference should be given to leaving the independence principle intact. Only in exceptional circumstances, in which it is absolutely and manifestly clear that the beneficiary would have to return the money immediately and in full as soon as it receives it, can there be room for a different approach. This would constitute a violation of the independent nature of the guarantee, so that compelling evidence and extraordinary circumstances are necessary in order to justify interference with the regular discharge procedure and the principle of independence upon which the popularity of demand guarantees is founded.

5.9 Extend or pay problem

Another potential manifestation of abusive behaviour that may arise in the context of demand guarantees relates to the so-called "extend or pay" demand.[473] Demand guarantees mostly contain an expiry date.[474] Guarantors generally insist upon this.[475] After expiry of the

[471] See par 3.4.2.4 above.

[472] Coleman (n 107) 238 uses the term "risk distribution device".

[473] For an example of such a demand see *GKN Contractors Ltd v Lloyds Bank plc* (n 33) 59.

[474] Davis (n 207 *2014*) 803 par 19-037; Bertrams (n 7) 98 par 8-12 and 244 par 12-38; Graf von Westphalen and Zöchling-Jud (n 90) 646 par 172; Willmann *Die Bankgarantie im Bauwesen* (2013) 79 par 2.2.6.2; Horn and Wymeersch (n 1) 6 par 2; Garner *JBCC 2014 and all that* (2014) 78 and 104; and Pleyer "Die Bankgarantie im zwischenstaatlichen Handel" 1973 *WM* (Sonderbeilage 2/1973) 17 par 1. Note also the provision in the UNCITRAL Convention (Art12(c)), which stipulates for automatic expiry of the guarantee after six years, should the guarantor have failed to insert an expiry date.

[475] Wood (n 105) 366 par 20-003; and Schütze and Edelmann (n 283) 57 par 2.2. See *Mutual and Federal v KNS Construction* (n 317). This case related to a contract of security which did not contain an expiry date. The SCA eventually deemed it to be a mere accessory guarantee. It is suggested that the lack of an expiry date may have possibly contributed to the court's reasoning regarding the accessory nature of the instrument (see par 1 and 14).

guarantee no demand can be made and the guarantor's obligations are discharged.[476] Therefore, a beneficiary may decide,[477] once the expiry date draws near, to call up the guarantee on an "extend or pay" basis.[478] In such a case, the beneficiary would effectively demand the validity of the guarantee to be extended ("extend") or to be paid ("pay") in the alternative ("extend or pay"). The guarantor, after having satisfied itself that the demand is formally compliant,[479] will then approach the applicant and request its approval to extend the expiry date.[480] Understandably, this can put enormous pressure on the guarantor and the applicant who may see themselves forced to agree to an extension of the guarantee in order to avoid, or at least delay, payment.[481] It should be emphasised, however, that this practice is not necessarily *per se* questionable, abusive or fraudulent.[482] Bertrams clarifies:

> "When the beneficiary secures an extension by means of an 'extend or pay' request, he is effectively exercising a power inherent in first demand guarantees, not a right. […T]his does not in itself imply

[476] Bertrams (n 7) 254 par 12-49, 311-312 par 13-22 and 314 par 13-23; Schütze and Edelmann (n 283) 56 par 2.2; and Blesch and Lange (n 132) 142 par 524-525. Regarding jurisdictions which may *not* accept expiry dates, see Graf von Westphalen and Zöchling-Jud (n 90) 646 par 172; Schütze and Edelmann (n 283) 59-60 par 2.4; Blesch and Lange (n 132) 175-176 par 579; and Bertrams (n 7) 254-259.

[477] Affaki and Goode (n 88) 148 par 454, with reference only to an UNCITRAL document ("UN doc. A/CN.9/WG.II/WP.71") mention that up to 90% of the demands presented to banks as guarantors are of this nature. Graf von Westphalen and Zöchling-Jud (n 90) 232 par 261 (n 480) also make an unqualified reference to the same UNCITRAL document, as does Bertrams (n 7) 245 par 12-40 to substantiate the statement that "95% of the calls on first demand guarantees concern 'extend or pay' requests". The document concerned is less definite. It simply sates: "Reportedly, banker's [sic] estimate that well over 90 per cent of the calls on first demand guarantees concern 'extend or pay' request […]". See *Yearbook of the United Nations Commission on International Trade Law* (1991) 352 361 par 51.

[478] McKendrick (n 49) 1141 par ix; Bridge (n 29) 2235 par 24-070; and Ehrlich and Haas (n 146) 464 par 9/118. For such an "extend or pay" demand, see LG Frankfurt 1981 *WM* 284; and BGH 1996 *NJW* 1052. The interesting reversed case of a beneficiary demanding "pay or extend" is discussed in Affaki and Goode (n 88) 149 par 456. There, it is argued that "where the beneficiary simply requests an extension, sometimes coupled with an intimation that, if extension is not granted, a demand for payment will follow, the beneficiary cannot be regarded as having presented a demand to be examined for compliance".

[479] Graf von Westphalen and Zöchling-Jud (n 90) 232-233 par 262; Bertrams (n 7) 318; and Ehrlich and Haas (n 146) 464 par 9/118.

[480] Bertrams (n 7) 249-250 par 12-43. While the applicant's approval is not strictly necessary it secures the guarantor's right of recourse (reimbursement) against the applicant, should the guarantee eventually be called up and honoured.

[481] See, for example, the case of a desperate German seller of machinery to an Iranian entity in LG Frankfurt (n 478) who repeatedly gave in to such demands for extensions of the guarantee. Note also Arnold *Die Bürgschaft auf erstes Anfordern im deutschen und englischen Recht* (2008) 20 par IV; Bertrams (n 7) 246 par 12-40; and Förster *Die Fusion von Bürgschaft und Garantie* (2010) 348-349.

[482] BGH (n 478) 1052-1053 (by implication); Bertrams (n 7) 245 par 12-40 and 246 par 12-41; Graf von Westphalen and Zöchling-Jud (n 90) 235-236 par 269-271; Willmann (n 474) 77 par 2.2.6.1; Affaki and Goode (n 88) 148 par 454; Förster (n 481) 348-349; Ehrlich and Haas (n 146) 464 par 9/118; McKendrick (n 49) 1141 par ix; Oelofse (n 66 *Annual Banking Law Update*) 13 par 5; and Fedotov (n 105) 53.

> any improper conduct on the part of the beneficiary. Only the particular circumstances and motives may render the request oppressive."[483]

The beneficiary may, for instance, require extension of the guarantee's validity in order to grant the applicant additional time to rectify a breach of the underlying contract, instead of simply calling up the guarantee.[484] Another possibility is that the beneficiary is simply not able to ascertain immediately the extent of loss suffered or damaged caused, and accordingly prefers to wait with a definite call on the guarantee without risking the expiry thereof.[485] Since extend-or-pay requests are a regular occurrence in commercial practice,[486] both the URDG 758 and the ISP98 recognise and deal with them – which contributes to their legitimacy.[487] Article 23 of the URDG reads as follows:

> "Extend or pay
>
> a. Where a complying demand includes, as an alternative, a request to extend the expiry, the guarantor may suspend payment for a period not exceeding 30 calendar days following its receipt of the demand. […]
>
> c. The guarantor shall without delay inform the instructing party […] of the period of suspension of payment under the guarantee. […] Complying with this article satisfies the information duty under article 16.
>
> d. The demand for payment is deemed to be withdrawn if the period of extension requested in that demand or otherwise agreed by the party making that demand is granted within the time provided under paragraph (a) […] of this article. If no such period of extension is granted, the complying demand shall be paid without the need to present any further demand.
>
> e. The guarantor […] may refuse to grant any extension even if instructed to do so and shall then pay.
>
> f. The guarantor […] shall without delay inform the party from whom it has received instructions of its decision to extend under paragraph (d) or to pay.
>
> g. The guarantor […] assume[s] no liability for any payment suspended in accordance with this article."[488]

The ISP98 in rule 3.09 stipulate in regard to an extend-or-pay demand:

> "Extend or pay

[483] (n 7) 246 par 12-41 (insertion and alteration by me).

[484] Willmann (n 474) 78; McKendrick (n 49) 1141 par ix; Affaki and Goode (n 88) 148 par 454; Bertrams (n 7) 245 par 12-40; and Graf von Westphalen and Zöchling-Jud (n 90) 646 par 171.

[485] Bertrams (n 7) 245 par 12-40; Ehrlich and Haas (n 146) 464 par 9/118; and Förster (n 481) 349.

[486] Willmann (n 474) 77 par 2.2.6.1; and Bertrams (n 7) 245 par 12-40.

[487] On this point, see the criticism in Heidbüchel (n 5) 109 ("Zum einen würde der Begünstigte durch eine Regelung des 'extend or pay'-Verlangen zu diesem aufgrund des hohen Mißbrauchsrisikos unerwünschten Vorgehen noch ermutigt").

[488] omissions and insertion by me.

> A beneficiary's request to extend the expiration date of the standby or, alternatively, to pay the amount available under it:
>
> (a) is a presentation demanding payment under the standby, to be examined as such in accordance with these Rules; and
>
> (b) implies that the beneficiary:
>
> > (i) consents to the amendment to extend the expiry date to the date requested;
> >
> > (ii) requests the issuer to exercise its discretion to seek the approval of the applicant and to issue that amendment;
> >
> > (iii) upon issuance of that amendment, retracts its demand for payment; and
> >
> > (iv) consents to the maximum time available under these Rules for examination and notice of dishonour."

Both the URDG 758 and the ISP98 treat an extend-or-pay demand similarly: it is recognised that such a demand necessitates additional time for examination and consideration, which enables the guarantor to consult with the applicant and decide, in its own discretion once consent has been given, whether to extend the expiry date of the instrument or not. Moreover, the two sets of rules make it clear that to be considered the demand must be, in any event, a formally compliant one. If the guarantor rejects the demand for an extension, and the presentation is a compliant one, the guarantee must be paid.

Essentially, therefore, an extend-or-pay demand should be treated in the same way as a normal demand. If it satisfies the test for fraud in England and South Africa, or for *Rechtsmissbrauch* in German law, this will open the way for the applicant or guarantor to resist payment. If not, the guarantor must either pay or extend the validity of the guarantee with the permission of the applicant (in other words amend the instrument in accordance with the demand).[489]

5.10 Conclusion

This discussion concludes Chapter Five which dealt with demands for payment that are abusive or impermissible due to the conduct of the beneficiary in relation to, first and foremost, the *underlying contract*. Providing the guarantor with a defence to such demands necessitates the violation of the independence principle. The most important examples are the

[489] Naturally, this exposes the guarantor – and thus the applicant as it is liable for reimbursement – for a longer period of time, and extends the contract of mandate which requires the consent of both parties. See Schütze and Edelmann (n 283) 106 par 1; and Bertrams (n 7) 249-250 par 12-43.

fraud exception in English and South African law, and the *Rechtsmissbrauch* defence in German law. The following Chapter Six explores calls on demand guarantees which are also abusive and objectionable. The potential defences against these demands for payment, however, do not originate from the underlying contract but are to be found in *the guarantee* itself and *the terms* contained therein. This way, the independence principle is generally not an issue in the following chapter.

Chapter Six: Documentary compliance, identity of the parties, and other defences based on the guarantee and its terms

6.1 Introduction

The research presented in the previous chapter[1] explored instances of abuse of demand guarantees which are abusive due to the conduct of the beneficiary in regard to, primarily, the *underlying contract*. The research in this chapter concerns calls on demand guarantees which may be abusive in respect *of the guarantee and its terms*, and therefore could potentially offer the guarantor a valid defence against such demands without violating the principle of independence. The following assessment covers the issue of documentary compliance in general and the proper identification of the parties in particular.[2] Further, the return of the guarantee and partial as well as multiple demands are examined.[3] Moreover, defences based on the terms of the guarantees, especially in regard to variable construction guarantees and retention money guarantees, are explored.

It is important to appreciate the fact that instances of potentially impermissible demands and respective defences for the guarantor dealt with in this chapter do not concern the principle of independence at all. On the contrary, it is the guarantee itself, and the respective terms contained therein, which may offer a valid defence. This observation motivated the separation from the research presented in Chapter Five above, and the dedication of this chapter in the thesis.

6.2 Principle of documentary compliance and abusive demands

6.2.1 Introduction

The principle of documentary compliance is essential for the proper operation of demand-guarantee transactions.[4] As explained above, the beneficiary may claim under the guarantee provided it tenders the documents specified in the guarantee itself. In the construction industry these documents are usually a written demand for payment stating the amount claimed and a declaration by the beneficiary alleging breach of contract by the applicant,[5] and, possibly, a notice of cancellation of the underlying construction contract and/or the

[1] par 5.2-5.9 above.

[2] par 6.2-6.3.5 below.

[3] par 6.4.

[4] See also par 3.4.3 above.

[5] par 5.2.6 above.

original guarantee.[6] If the documents submitted comply with the requirements of the guarantee, the demand must be honoured. If the documents are non-complying, however, the guarantor is entitled to reject the demand.[7] Regarding documentary compliance in connection with fraud, Kelly-Louw states:

> "Case law and legal writing sometimes treat non-compliance with the terms and conditions of the demand guarantee as an exception to the bank's payment obligation on the same footing as fraud. This is confusing, as well as incorrect, since this defence is solely and directly based on the terms of the guarantee itself with the result that the payment obligation does not materialise. Non-compliance with the terms of the demand guarantee has nothing to do with fraud."[8]

Although this statement as it stands is clearly correct, it is submitted that it would be wrong to conclude that there can be no connection between documentary compliance and abusive demands.

There can be, for example, a nexus between *documentary compliance* on the one hand, and the *fraud exception* on the other hand. If the guarantee requires of the beneficiary to issue a statement alleging breach of contract by the applicant, the beneficiary's conforming statement can conceivably be fraudulent.[9] This will be the case in the event of the beneficiary not having an "honest belief"[10] in the validity or truthfulness of its statement or having "knowledge of its lack of entitlement".[11] In such a case payment can be interdicted on the basis of fraud irrespective of the fact that the demand is in formal compliance with the terms of the guarantee.

6.2.2 Documentary non-compliance: right to reject demand for payment

Another aspect relates to the question as to *what* constitutes a (non)compliant presentation, what legal yardstick is applicable to measure compliance, and what issues arise from this discussion for purposes of identifying ways to counter abusive demands. This particular topic forms the centrepiece of this section. It is submitted that the presentation of incomplete

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[6] par 6.4 below.

[7] Regarding the required "strictness" of the principle of documentary compliance in recent South African case law, see *Kristabel Developments (Pty) Ltd v Credit Guarantee Insurance Corporation of Africa Limited* [2015] ZAGPJHC 264 (20 October 2015) par 19 *et seq*.

[8] *Selective Legal Aspects of Bank Demand Guarantees* (2009) 218 (her footnote omitted).

[9] par 3.4.3.1 above.

[10] especially in English law. See par 5.2.3 above.

[11] See the discussion of the fraud exception in South African law, par 5.2.4-5.2.5 above.

demands or ambiguous statements, be it deliberate or at least knowingly, for the purpose of obtaining payment could also be seen as improper and potentially abusive conduct by the beneficiary.[12] If such a demand could be resisted by way of rejection because of *non-compliance* or *documentary non-conformity*, guarantors and applicants would increase their chances of successfully curbing abusive demeanour. This is based on the fact that the claim for payment under a demand guarantee only materialises once the documentary requirements are fulfilled[13] – incomplete presentations can be rejected by the guarantor without undermining the independence principle of the instruments and without damaging its own reputation as a reliable financial institution.

Thus, and in line with Kelly-Louw's elaboration, instances of non-compliant demands can be dealt with without any recourse to complicated notions of fraud or *Rechtsmissbrauch*, which would almost inevitably invite legal debates on fraudulent intentions and compelling proof thereof. Accordingly, the decisive question relates to the strictness of compliance in the called-upon jurisdiction and legal frameworks.

The ISP98, for example, prescribe the content and wording required for a demand to conform under these specific rules: if the instrument requires "a statement without specifying precise wording, then the wording in the document presented *must appear to convey the same meaning* as that required by the standby".[14] Should the standby letter of credit, however, stipulate for

> "specified wording by the use of quotation marks, blocked wording, or an attached exhibit or form, and also provides that the specified wording be "*exact*" or "*identical*", then the wording in the documents presented must *duplicate the specified wording*, including typographical errors in spelling, punctuation, spacing and the like, as well as blank lines and spaces for data must be exactly reproduced."[15]

The drafters of the ISP98, as one can see, have taken a decision based on commercial analysis and public policy and included this differentiation into their framework – it distinguishes between instruments opting for exact and identical wording prescribed for the demands, and such contracts which do not call for precise wording.

[12] For instance, see the discussion by Parker LJ in *GKN Contractors Ltd v Lloyds Bank plc* [1985] 30 Building LR 48, especially 60-65.

[13] See Kelly-Louw's statement above.

[14] ISP98 rule 4.09 (a) (emphasis by me).

[15] ISP98 rule 4.09 (c) (emphasis added by me).

The jurisdictions most relevant to this study, England, Germany, and South Africa, have also developed and interpreted their laws which are dealt with immediately below.

6.2.3 Documentary compliance under English law

As was remarked above,[16] instances of non-compliant demands are usually rejected without recourse to defences relating to the fraud exception. In English law the principle is well-established that if the presentation is incomplete or otherwise does not comply with the requirements of the guarantee, the guarantor is under no obligation to pay. In this context, the crucial question relates to the degree of strictness necessary in assessing documentary compliance. The position is not clear from the English cases from which different and almost contradictory notions of interpretation and reasoning have emerged over time in this regard.

In *Siporex Trade v Banque Indosuez*,[17] one of the earliest decisions in point,[18] the court drew a distinction between letters of credit and demand guarantees regarding the level of documentary compliance.[19] Hirst J held:

> "[I]n a letter of credit the bank is of course dealing with the very documents themselves, and is obliged to compare with meticulous care those tendered with those prescribed in the mandate, whereas in the present case [demand-guarantee transaction] the bank is dealing with no more than a statement in the form of a declaration to the effect that a certain event has occurred."[20]

He went on to say that nevertheless, "there should be no ambiguity, no risk of the bank being misled, and no risk of it being confused or otherwise prejudiced".[21] In applying these principles, however, the court showed leniency and tolerance in accepting as valid a demand by the beneficiary, which deviated from the conditions set forth in the guarantee.[22] It is

[16] See par 6.2.2 above.

[17] [1986] 2 Lloyd's Rep 146 (QB).

[18] Ellinger and Neo *The Law and Practice of Documentary Letters of Credit* (2010) 326 (n 98).

[19] See the particular discussion by Hirst J (158 *et seq*).

[20] 159 (insertion by me).

[21] 159.

[22] 158-160 of the judgment. *Inter alia*, the letter of demand made reference to an incorrect date on which the underlying contract had been concluded, and it declared that "no valid letter of credit" had been obtained, whereas the guarantee called for a statement that "no letter of credit has been issued". Therefore, Kelly-Louw "The doctrine of strict compliance in the context of demand guarantees" 2016 *Comparative and International Law Journal of Southern Africa* 85 97 argued that this case "offers some authority for the proposition that the doctrine does not apply with the same rigour when it involves demand guarantees".

accordingly clear that the *Siporex* case followed and developed a moderate, lenient and almost flexible approach to compliance in the demand guarantee context in English law.

Similar sentiments arose in *IE Contractors Ltd v Lloyds Bank Plc and Rafidain Bank*.[23] Staughton LJ put it thus:

> "I agree that there is less need for a doctrine of strict compliance in the case of performance bonds, since I imagine that they are used less frequently than letters of credit, and attract attention at a higher level in banks. They are not so much part of the day-to-day mechanism of ordinary trade."[24]

He went on to stress, however, that the question of construction of the instrument was important in this regard:

> "The degree of compliance required by a performance bond may be strict, or not so strict. It is a question of construction of the bond. If that view of the law is unattractive to banks, the remedy lies in their own hands."[25]

The explanation given by Staughton LJ, however, has been criticised as lacking in proper guidance and clear direction. It was argued that "it might not be easy for these high-level bank personnel to gauge what degree of compliance would be sufficient in a performance bond if strict compliance was not required".[26]

In *Frans Maas (UK) Ltd v Habib Bank AG Zurich*,[27] however, the court adopted a stricter approach.[28] In dealing with the question of compliance the court stated:

> "I therefore address the question whether, as a matter of construction, the words 'we claim the sum of £500,000, Palmier plc having failed to meet their contractual obligations to us' comply with the requirement of the guarantee that the claims should '[state] therein that the Principals have failed to pay you under their contractual obligation'. In my judgment, the answer to that question is 'No'."[29]

The court, moreover, placed importance on the "issue of construction" and the "purpose of the [underlying agreement] as part of the surrounding circumstances" when elaborating on the question whether the demand met the threshold for documentary compliance under the

[23] [1990] 2 Lloyd's Rep 496 (CA).

[24] 500.

[25] 501.

[26] Ellinger and Neo (n 18) 327 par ii.

[27] [2001] Lloyd's Rep Bank 14.

[28] See, for instance, the assessments in Bertrams *Bank Guarantees in International Trade* (2013) 298 (n 39) ("for a rigid application of the rule of strict compliance in respect of the statement of default"); and Kelly-Louw "General update on the law of demand guarantees and letters of credit" 2016 *Annual Banking Law Update* 43 57-58.

[29] 59 (per Bellamy QC).

guarantee.[30] A similar stricter approach was favoured in *Sea-Cargo Skips AS v State Bank of India*[31] in which Teare J held as follows:

> "For my part I would respectfully doubt that there is less need for a doctrine of strict compliance in the field of performance bonds than in letters of credit. In the field of performance bonds, as in the field of letters of credit, the banks who provide the bonds deal with documents. Banks must honour their obligation to pay if documents which conform with the requirements of the bond are tendered. Thus the banks must determine, on the basis of the presentation alone, whether it appears on its face to be a complying presentation […]."[32]

He then, however, approvingly cited *dicta* by Staughton and Buckley LJJ in *IE Contractors Ltd v Lloyds Bank Plc and Rafidain Bank*, and decided that indeed the question of compliance rested on the construction and interpretation of the guarantee and the intentions of the parties.[33]

In the recent Scottish case of *East Ayrshire Council v Zurich Insurance Public Limited Company*,[34] Lord Malcom summarised the current state of the law relating to documentary compliance and demand guarantees as he perceived it, when he explained that:

> "Whether exact or strict compliance with any agreed style or form is required again depends upon the terms of the bond. There are cases where it has been held sufficient for the demand to deal with the substance of what is required, rather than slavishly duplicate precise wording."[35]

The learned judge continued to elaborate, and it is submitted that the following passages are especially noteworthy:

> "The degree of formality, technical precision and strict accuracy required of a certificate, notice or demand provided for in an agreement, depends upon the proper construction of the parties' intention in this regard as expressed in the relevant deed, and with regard to the shared knowledge of the relevant surrounding circumstances, including the nature and purpose of the contract."[36]

Further, he argued:

> "In my view, in the context of a demand bond of this nature, and unless the contrary appears from its face, if the parties agree that three matters require to be certified, then each is necessary for a valid demand. […] The certificate of default was to contain certification of non-compliance by the company for at least 60 days. That is a wholly understandable and significant element of a conclusive demand of the present kind. It gives the company notice that the beneficiary is contemplating recovery under the bond and it provides some comfort to the defender that there has been a default. To my mind it would

[30] 60 (alteration by me).

[31] [2013] EWHC 177 (Comm).

[32] par 27 (omission by me).

[33] par 28-30.

[34] [2014] CSOH 102. As was indicated, it must be noted that this judgment is a Scottish case.

[35] par 18.

[36] par 19.

> be surprising if the beneficiary in the bond could simply decide that such a notice would achieve nothing, and therefore could be set aside with impunity."[37]

The court then specifically addressed the issue of legal certainty, and emphasised its high value to the parties involved in guarantee transactions:

> "Notwithstanding the liability to pay on the basis of the agreed certificate, should the defender be taken as having agreed that there can be circumstances in which a 60 day notice procedure is not required, and if so, what are those circumstances? As soon as one asks such questions, the difficulties and uncertainties are obvious. It seems to me to be reasonable to conclude that the guarantor, who [is] required to pay whatever the underlying situation, wanted some reassurance on the face of the certificate that there was good reason for the bond being called up. […] The correct construction of the agreement cannot depend on what does or does not seem reasonable in the particular circumstances of a particular case. That would be to risk re-writing the parties' agreement on the basis of what, at this point in time, seems fair and equitable."[38]

Eventually, the court decided that it would be improper "to expect on demand payment unless the documentation is compliant with the bond",[39] denied enforcement of the independent guarantee and thereby strengthened the notion of a more strict documentary compliance requirement.

Regarding academic commentary on this aspect, it was suggested in *Jack: Documentary Credits* "that the principle of strict compliance can and should be applied to demand guarantees and bonds to the extent that the wording of the guarantee or bond makes it appropriate".[40] Although this is probably a fair reflection of the current state of English law, other commentators have levelled criticism at the English courts for their vague explanations and the lack of clear and proper guidance in this regard.[41]

6.2.4 Documentary compliance under German law

Documentary compliance relating to demand guarantees in German law, and the question of the appropriate level of strictness, has also been discussed in case law and scholarly writing. Generally, the demand for payment under the independent guarantee must fulfil the formal requirements set forth in the instrument, and all required documents prescribed, if any, must

[37] par 22 (omission by me).

[38] par 23 (omission and insertion by me).

[39] par 26.

[40] Malek and Quest *Jack: Documentary Credits* (2009) 367 par 12.71 (their footnote omitted).

[41] For example, Ellinger and Neo (n 18) 327 par ii.

be tendered to the guarantor to assess the demand's validity.[42] This is firmly established and, as in South Africa and England, is part of the law on demand guarantees.

However, the German *Bundesgerichtshof* has mitigated the strictness of the rule regarding documentary compliance to a degree. On several occasions the court has held that a demand does not need to be phrased verbatim and literally as prescribed in the guarantee, unless a specific stipulation to this effect has been included in the instrument.[43] If the statements by the beneficiary in the demand, however, deviate substantially from the formal requirements stated in the instrument, German courts will deny enforcement.[44] Also, if required documents are not attached to the demand and no rectification and subsequent submission is done timeously – that is before expiry of the guarantee – the guarantor may declare the demand to be incomplete and non-compliant.[45]

Commentators seem to be in agreement that the principle of documentary compliance in demand guarantees should be applied reasonably strictly ("Grundsatz der formalen Garantiestrenge" and similarly "Grundsatz der 'strikten' Observanz").[46] In conclusion, under German law the raising of the *Rechtsmissbrauch* doctrine to resist the demand for payment is

[42] BGH 1996 *NJW* 1052; BGH 1996 *WM* 770; and BGH 1984 *WM* 44. See also BGH 2001 *WM* 1208 (although involving a German "Bürgschaft auf erstes Anfordern", the judgment and its reasoning is equally applicable to demand guarantees). See par 4.5.2 above.

[43] See, for example, BGH 1997 *WM* 656 659; and BGH *BGHZ* 145, 286 293 where it was held: "Einer wörtlichen Übereinstimmung mit dem Urkundeninhalt […] bedarf es indes nur, wenn das ausdrücklich vereinbart wurde. In allen anderen Fällen genügt es, wenn die garantievertraglichen Voraussetzungen der Zahlungspflicht in einer für den Garanten unmißverständlichen Weise zum Ausdruck gebracht werden […]" (omissions and insertions by me).

[44] See OLG Frankfurt 23 U 67/15 (06.11.2015) (juris), especially par 30-36. The court held: "Nach dem Grundsatz der Garantiestrenge liegt somit hierin offensichtlich keine formwirksame, der Garantieurkunde entsprechende Zahlungsaufforderung vor" (par 32).

[45] BGH (n 42 *NJW*) 1053 ("Eine solche Erklärung, auf die bei der vereinbarten Garantie auf erstes Anfordern nicht verzichtet werden kann und die nach dem Grundsatz der Garantiestrenge so abzugeben ist, wie sie in der Garantieurkunde niedergelegt ist […] hat die Klägerin der Beklagten bis zum Fristablauf nicht übermittelt" – omission of the cited authority by me); and BGH (n 42 *1996 WM*) 771 par II.1.a ("Ist dort über die Zahlungsaufforderung hinaus die Einreichung von Unterlagen vorgesehen, so müssen diese bei Inanspruchnahme der Garantie vorgelegt werden. Geschieht dies nicht fristgerecht, so liegt eine wirksame Inanspruchnahme nicht vor").

[46] Canaris *Bankvertragsrecht Erster Teil* (1988/2005) 769 par 1133; and Graf von Westphalen and Zöchling-Jud *Die Bankgarantie im internationalen Handelsverkehr* (2014) 189 par 177 (with several authorities in their (n 271) and (n 272)). At 192-194 par 183-187, however, a more lenient approach which may allow for interpretation of statements by the beneficiary in order to meet the requirements of the principle of documentary compliance under German law. See also Ehrlich and Haas *Zahlung und Zahlungssicherung im Außenhandel* (2010) 461 par 9/115 (indirectly arguing for a strict approach), but also 459 par 9/111 (seemingly support for a less rigid interpretation of the doctrine of documentary compliance with reference to BGH *BGHZ* 145, 286); Klaas "Formelle Garantiestrenge im Recht der Bankgarantie" 1997 *Zeitschrift für Wirtschaftsrecht* (*ZIP)* 1098; and Rüßmann "Die Auswirkungen des Grundsatzes der formellen Garantiestrenge auf die Geltenmachung einer befristeten Garantie auf erstes Anfordern" 1995 *WM* 1825.

both unnecessary and inappropriate in cases of non-compliant demands: a formally defective demand can be rejected simply on the basis that it already lacks the formal requirements to compel the guarantor to honour its promise under the guarantee.

6.2.5 Documentary compliance under South African law

In South Africa, the courts have had several opportunities to deal with documentary compliance in the context of demand guarantees.

In *Compass Insurance v Hospitality Hotel Developments*,[47] the beneficiary of a performance guarantee demanded payment after a subcontractor was provisionally wound up. The guarantee stipulated that the demand was to be accompanied by either a copy of the notice of cancellation, or a copy of the court order granting provisional sequestration or liquidation of the subcontractor concerned.[48] The demand, however, contained neither and the guarantor refused payment on the basis of the demand being defective.[49] The guarantee contained a specific expiry date (30 April 2008),[50] and "[t]he copy of the court order was delivered only months later, on 26 November 2008, long after the expiry of the guarantee".[51] The beneficiary, however, argued that

> "[…] all concerned knew that the subcontractor had in fact been liquidated; there was some difficulty in obtaining the order, however, and that once there was knowledge of the existence of the order that was sufficient for demand to be made. The demand was not defective, it contended, despite the failure to attach the order to it. Strict compliance with the terms of the guarantee was not required."[52]

This argument prevailed in the court a quo, and the guarantor appealed. In the Supreme Court of Appeal Lewis JA, after considering legal scholarship and several authorities, domestic and English, concluded:

> "In my view it is not necessary to decide whether 'strict compliance' is necessary for performance guarantees, since in this case the requirements to be met by [the beneficiary] in making demand were

[47] 2012 (2) SA 537 (SCA). For a discussion of this case see also Hugo "Construction guarantees and the Supreme Court of Appeal (2010 – 2013)" in Visser and Pretorius *Essays in Honour of Frans Malan* (2014) 159 170-171; as well as Kelly-Louw and Hugo "Documentary credits and independent guarantees" 2012 *Annual Banking Law Update* 73 76-77 par 2.2.

[48] See par 4.

[49] par 3.

[50] par 5. For the importance of expiry dates in demand guarantees and so-called "extend or pay demands", see par 5.9 above.

[51] Lewis JA, par 5 (alteration by me).

[52] Lewis JA, par 7 (alteration by me).

> absolutely clear, and there was in fact no compliance, let alone strict compliance. The guarantee expressly required that the order of liquidation be attached to the demand. It was not."[53]

The court accordingly avoided deciding the point whether strict compliance was required in the law relating to demand guarantees (as in the case of documentary credits), or whether a lesser form of complianc (substantial compliance) was applicable. The same approach was adopted by the SCA in the subsequent case of *State Bank of India v Denel SOC Limited*.[54]

Against this background Satchwell J was clearly correct when she stated, in the *Group Five* case, that in South Africa "the SCA has refrained from deciding whether or not this doctrine of strict compliance is equally applicable to demand guarantees."[55] Since the case was finally decided on the basis of the fraud exception,[56] it was unnecessary for Satchwell J to decide this issue at that time.

Shortly thereafter, however, the question came before her again in the case of *Kristabel Developments (Pty) Ltd v Credit Guarantee Insurance Corporation of Africa Limited*.[57] In this case the guarantee stipulated for a written demand and a copy of the notice of cancellation of the underlying construction contract.[58] The beneficiary submitted a copy of the letter of cancellation to the guarantor on 20 May 2014, but without the required demand.[59] Conversely, when finally sent on 4 June 2014, the demand did not have a copy of the cancellation notice attached to it.[60] Satchwell J condensed the legal question to the following:

> "The […] issue is whether or not 'prior' compliance rather than 'contemporaneous' compliance in the context of this particular matter means there has not been the required compliance with the […] guarantee."[61]

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[53] par 13 (alteration by me).

[54] [2015] 2 All SA 152 (SCA). For a case discussion, see Kelly-Louw and Marxen "General update on the law of demand guarantees and letters of credit" 2015 *Annual Banking Law Update* 276 277-287; and Kelly-Louw (n 22) 116-125.

[55] *Group Five Construction (Pty) Limited v Member of the Executive Council for Public Transport Roads and Works Gauteng* [2015] ZAGPJHC 55 (13 February 2015) par 23 (n 4). For a case discussion, see Kelly-Louw and Marxen (n 54) 294-295.

[56] par 38 *et seq*.

[57] n 7. Although not relevant for the particular discussion at hand, one should note that the original judgment seems to contain a subsequent, hand-written alteration to the order which is not reproduced in the judgment repository provided by the Southern African Legal Information Institute (SAFLII). The additional remark relates to the period of interest due, and can accordingly be disregarded for purposes of this discussion.

[58] par 19.

[59] See par 22.

[60] par 23.

[61] par 25 (omissions by me).

After assessing several authorities from South Africa and England,[62] she pointed out again that the South African courts have not yet found it necessary "to determine whether or not "strict" compliance is required of the beneficiary under a performance guarantee."[63] She went on to consider the *Compass Insurance* case in detail[64] and finally concluded:

> "In the present case, the notice of cancellation did exist. It was sent to the guarantor and received by the guarantor. Guarantor's attorneys were also copied on the correspondence arranging meetings to discuss this cancellation in May 2014. The existence of the cancellation and the reasons therefor were known to the guarantor *at the time demand was made*."[65]

Against this background she held:

> "[…] to find that failure to attach a written cancellation already received and under discussion, constitutes complete non-compliance with the terms of the guarantee and therefor disentitles the beneficiary […] from proceeding with its demand under that guarantee is, I believe, a step too far. The reason requiring compliance with terms of the guarantee, especially as restated by the Supreme Court of Appeal in Compass *supra*, are carefully kept in mind in the present instance.
>
> Accordingly, I find that the prior presentation of the cancellation by applicant to respondent (and to respondent's attorneys) instead of contemporaneous presentation with the demand constitutes, *in these circumstances*, compliance with the guarantee."[66]

The judgment accordingly distinguishes the *Compass Insurance* case, since, in that case, the copy of the required document only reached the guarantor after the demand, and more importantly, *after expiry* of the guarantee – and for this reason the demand was regarded as incomplete and non-compliant. In the *Kristabel Developments* case, on the other hand, all necessary documents had been received by the guarantor prior to the expiry of the guarantee – although not contemporaneously. In conclusion the guarantor, so the court reasoned,

> "was not required to go on an expedition to establish the truth of the averment in the demand that there had been cancellation – it had already received the notice of cancellation. The guarantor […] was not asked to make enquiries as to the grounds given for cancellation – it already knew that the notice of cancellation claimed 'breach'. The guarantor […] was never under any illusions or doubts nor was it ever asked to go beyond its independent and autonomous contract with the beneficiary/applicant and make any enquiries of third parties. It had all the necessary information to hand – a valid notice of cancellation."[67]

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[62] Satchwell J consulted, *inter alia*, *Lombard Insurance Company Ltd v Landmark Holding (Pty) Ltd* 2010 (2) SA 86 (SCA), *OK Bazaars (1929) Ltd v Standard Bank of South Africa Limited* 2002 (3) SA 688 (SCA), *Loomcraft Fabrics CC v Nedbank Ltd* 1996 (1) SA 812 (A), and *IE Contractors Ltd v Lloyds Bank Plc and Rafidain Bank* (n 23).

[63] par 31.

[64] par 31-33.

[65] par 34 (emphasis added by me).

[66] par 38-39 (omissions by me, emphasis added).

[67] par 53 (omissions by me).

The careful qualification of Satchwell J in the *Kristabel Developments* case restricting her finding to a demand "in these circumstances",[68] must, however, be emphasised. Apart from the fact that her judgment is clearly not concerned with a situation, such as in *Compass Insurance*, where the documents are tendered after expiry of the guarantee, it is suggested that it cannot be relied upon as authority in a situation where the document or documents delivered separately from the demand are unclear or confusing. This, in fact, is clearly evident from another judgment by the same judge in *Group Five Construction (Pty) Limited v Member of the Executive Council for Public Transport Roads and Works Gauteng*.[69]

In this case the beneficiary argued that the required notice provided to the guarantor non-contemporaneously to the demand (but before expiry thereof) took the form of a summons (containing different causes of action pleaded in the alternative) together with a plethora of attached documents.[70] This argument was rejected by Satchwell J who pointed out:

> "The summons and particulars of claim do not meet the requirement for a 'clear and unequivocal' notice of intention to cancel or notice of termination […]. It follows, that I cannot accept that the summons and particulars of claim contains within itself or constitute a notice of cancellation or confirmation of cancellation in respect of the […] building contract which is the subject matter of this guarantee."[71]

It is submitted that the judgments of Satchwell J in the *Group Five* and *Kristabel Developments* cases have contributed significantly to a proper understanding of documentary compliance in South African law. They show a keen appreciation of the underlying legal policy of the principle of documentary compliance which, essentially, is that each party must be able to know with certainty whether payment under the guarantee is due or not. No "expedition", as Satchwell J put it in *Kristabel Developments*, must be necessary on the part of the guarantor to establish the beneficiary's entitlement or disentitlement to payment under the guarantee.[72] Nor, as emerges from the *Group Five* case, can a demand be conforming if it is unclear and requires sophisticated legal analysis to determine exactly what it amounts to.

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[68] par 39.

[69] n 55.

[70] Especially par 22-37. Note, that Satchwell J rejected this notion in par 37. Eventually the court decided to resolve the issue by applying the fraud exception. Nevertheless, the elaborations in the judgment (in par 36-37 in particular) make it clear that such a demand is to be treated as non-compliant.

[71] par 36-37 (omissions by me).

[72] (n 7) par 53.

Moreover, these principles are in harmony with the point of departure of the judgment of Lewis JA in the *Compass Insurance* case:

> "It should not be incumbent on the guarantor to ascertain the truth of the assertion made by the beneficiary that the [applicant] had been placed under provisional liquidation. That is why [the guarantor] required a copy of the order itself. Similarly, the guarantor should not have to establish whether a contract has in fact been cancelled. That is why a copy of the notice of cancellation, if there has been in fact cancellation, is required to be attached to the demand […]."[73]

A further question regarding conformity emerged in the recent case of *University of the Western Cape v ABSA Insurance Company*;[74] the guarantee required a demand from the employer. The demand, however, when it was made, was made by the employer's agent on its own letterhead. In this regard the court, per Fourie J, held that "[t]he issue is therefore whether performance by a representative can be regarded as *strict compliance* with the terms of the guarantee."[75] The question was answered in the affirmative. Without distinct elaboration and almost in passing, it is respectfully submitted, it was implied that not only the principle of *documentary compliance*, but even one of *strict compliance* could be applicable to demand guarantees under South African law.[76] Due to the lack of detailed elaboration or distinction between the different degrees of potential strictness, it is suggested, this decision[77] should be viewed rather cautiously and critically.

Overall, the following conclusions can be drawn regarding the compliance of demands in South African law:

(i) Whether or not the doctrine of strict compliance, as applicable to letters of credit, is also applicable to guarantees is not entirely clear.[78]

(ii) Generally, however, compliance of the demand is important. If the guarantee is clear as to what is required and the requirements are not met, the guarantor is entitled to reject the demand (*Compass Insurance* case).

[73] (n 47) par 14 (omissions and insertions by me).

[74] [2015] ZAGPJHC 303 (28 October 2015). For a more detailed discussion, see par 6.3.2 below.

[75] par 10 (emphasis added by me).

[76] Also in *Grinaker LTA Rail Link Joint Venture v Absa Insurance Company Limited* [2015] ZAGPJHC 302 (10 November 2015) it was held that "Strict compliance with the terms of the guarantee is required" (per Fisher AJ par 14). Similarly, also this judgment did not sufficiently explain this statement, it is respectfully argued.

[77] As well as *Grinaker LTA Rail Link Joint Venture v Absa Insurance Company Limited* (n 76).

[78] Kelly-Louw (n 22) 113 and 125; Kelly-Louw (n 28) 58; and Hugo "Bank guarantees" in Sharrock *The Law of Banking and Payment in South Africa* (2016) 437 458.

(iii) All documents required by the guarantee need not be delivered contemporaneously, but all must be delivered before expiry of the guarantee (*Kristabel Developments* case read with *Compass Insurance* case).[79]

(iv) An unclear demand is likely to be regarded as non-conforming (*Group Five* case).

(v) A demand made by an agent of the person who in terms of the guarantee is supposed to be making the demand, can nevertheless be conforming (*University of the Western Cape* case).[80]

6.2.6 Documentary compliance and abusive demands: concluding remarks

The research has demonstrated that the question of documentary compliance in demand guarantees, and especially the appropriate strictness relating thereto, is not yet entirely settled in the jurisdictions examined. Further guidance through case law can be expected most probably in South Africa, as the South African courts have shied away from taking a definite stance. On the other hand, both English and German case law are unlikely to offer further direction to determine the required strictness for beneficiaries to claim under demand guarantees: English courts seem to be content with the formula that it depends on the wording of the guarantee, the construction of the contract and the intentions of the parties; German law does not necessitate absolute strictness and verbatim demands, or so it seems, unless the instrument stipulates so. Accordingly, all parties concerned with the guarantee transaction and the underlying contract are urged to agree on clear provisions in the guarantee if they want to ensure for strict documentary compliance to be applicable.[81]

Further, the advantages of raising the defence of non-compliance to a demand for payment must be highlighted again. No proof of abusive intentions, lack of an honest belief or *Rechtsmissbrauch* are required to deny payment under the guarantee; mere discrepancy in the stipulated documents as opposed to the tendered documents suffices to refuse payment under the guarantee. The process of rejection based on non-compliance is therefore a straightforward one, provided that the yardstick to compliance in demand guarantee is established. On the other hand – and this must be considered when rejecting demand for mere

[79] Akin to the German law as explored in par 6.2.4 above.

[80] For a full analysis of the case and the issue of agency in particular, however, see par 6.3.2 below.

[81] See also par 8.3 below.

non-conformity – stands the fact that a beneficiary may correct and rectify a previously non-compliant demand and succeed eventually.[82]

Incidentally, the URDG make provision for the situation in which the beneficiary makes an incomplete presentation: "A presentation has to be complete unless it indicates that it is to be completed later. In that case, it shall be completed on or before expiry."[83] Under this set of rules, an incomplete presentation is possible provided the beneficiary indicates the incompleteness and supplies the missing documents before expiry of the guarantee. This is in line with the German law and the South African position (*Kristabel Developments* and the *Compass Insurance* case). The ISP98, on the other hand, stipulate:

> "The receipt of a document required by and presented under a standby constitutes a presentation requiring examination for compliance with the terms and conditions of a standby even if not all of the required documents have been presented."[84]

It seems that under the ISP98, a guarantor must examine the demand and, as it is incomplete, reject it.

6.3 Identity of the parties and proper identification

6.3.1 Introduction

The identity of the parties and their proper identification in the underlying contract and in the demand guarantees are intrinsically linked to the issue of documentary compliance and the required degree of strictness. Because of the involvement of at least three independent contractual relationships (the underlying construction contract, the contract of mandate, and the demand guarantee agreement itself) there is the possibility of a party being incorrectly, insufficiently or ambiguously identified in one or more of the agreements. This is exacerbated by the fact that not all parties involved in the guarantee transaction may have had sight of the other contracts, as well as by renegotiation of agreements or re-issuance of expired or rejected guarantees. Also, the widespread and established practice in the construction industry

[82] See the remarks by O'Donovan and Phillips *The Modern Contract of Guarantee* (2010) 888 par 13-30. Of course this requires the demand to be rectified *before* the expiry of the guarantee, as otherwise the new submission of documents could be rejected yet again.

[83] art14 b.

[84] Rule 3.02

to form partnerships or joint ventures[85] when competing for contracts can aggravate difficulties relating to the identification of the parties. A further question in this broad context relates to the possibility of the beneficiary being replaced or legally succeeded by another person. The central issues, therefore, are: who is entitled to submit claims under the demand guarantee and what the consequences are of misleading or incorrect identification of parties in either the underlying contract or the demand guarantee? These questions are considered immediately below with reference to South African, English, German and American case law.

6.3.2 The beneficiary: agency and representation

The involvement of various "construction professionals",[86] for example engineers, architects and surveyors, lending their professional expertise to, and sometimes acting on behalf of, their principals is a common and accepted practice in the construction industry. The utilisation of such agents and representatives, however, may lead to problems when calls on demand guarantees are submitted through them. This is evident from the judgments of the *Oberlandesgericht Munich*[87] (Germany), the South African case of *University of the Western Cape v ABSA Insurance*,[88] and the English case of *Maridive and Oil Services (SAE) v CNA Insurance Company (Europe) Ltd*.[89]

In the *Oberlandesgericht Munich* case[90] the court had to deal with a demand that was submitted by an unnamed third party instead of by the beneficiary. As far as can be deduced from this very concise judgment[91] the demand stated that payment was to be effected into the beneficiary's account. The court had no trouble accepting in principle that an agent of the beneficiary can submit a claim on behalf of the beneficiary.[92] The claimant, however, did not

[85] See par 5.8 above.

[86] See par 2.2 above.

[87] OLG Munich 1999 *WM* 2456.

[88] n 74. Note also *Phenix Construction Technologies (Pty) Ltd v Hollard Insurance Company Limited* [2015] ZAGPJHC 282 (10 December 2015) par 18-19 for an interesting case in point. Opperman AJ (par 19), however, did not have to elaborate on this particular issue.

[89] [2002] EWCA Civ 369.

[90] n 87.

[91] It appears from the report that the litigants had waived their rights to a comprehensive judgment.

[92] See also Schütze "Zur Geltendmachung einer Bankgarantie 'auf erstes Anfordern'" 1981 *Recht der Internationalen Wirtschaft (RIW/AWD)* 83 84 par II 2.

(sufficiently) express that it was acting on behalf of the beneficiary. The court further expressed doubts whether, in any event, the claimant was properly authorised to act on behalf of the beneficiary in this regard. The court accordingly held that the demand was invalid and denied the claim for payment. A subsequent proper demand by the beneficiary was also unsuccessful since, by that time, the guarantee[93] had expired.

In *University of the Western Cape v ABSA Insurance*,[94] the court investigated the validity of a demand on a construction guarantee submitted by an agent of the beneficiary, and whether an agent's demand on behalf of the beneficiary could satisfy the requirement of compliance.[95] The facts were as follows: the University of the Western Cape entered into a building contract with a contractor, who was obliged, in accordance with the contract, to procure a construction guarantee to secure proper performance. The University additionally engaged LMC Project Management as its principal agent to oversee and manage the construction project. On application by the contractor, Absa Insurance issued a demand guarantee and delivered it to the employer, the University. The main stipulations of the guarantee, as set out in the judgment, were as follows:

> "Subject to the Guarantor's maximum liability … the Guarantor undertakes to pay the Employer the Guaranteed Sum or the full outstanding balance upon receipt of a *first written demand from the Employer* to the Guarantor at the Guarantor's physical address calling up this Construction Guarantee stating that:
>
> 5.1 The [underlying contract] has been cancelled due to the Contractor's default and that the Construction Guarantee is called up in terms of 5.0. The demand shall enclose a copy of the notice of cancellation […]"[96]

and

> "In the event of a call on this Guarantee, Payment will only be made against return of this original Guarantee by the *Employer* or the *Employer's duly authorised agent*."[97]

During the course of the construction work, the employer alleged defective performance and cancelled the contract. Subsequently, the employer "via the principal agent LMC Project Management" called up the guarantee, stating that the underlying agreement with the

[93] In fact, the instrument in question was not a proper demand guarantee, but a so-called "Bürgschaft auf erstes Anfordern". For purposes of this discussion, however, it is justified to assume this difference to be immaterial. See par 4.5.2 above for an introductory discussion of "Bürgschaft auf erstes Anfordern".

[94] n 74.

[95] The further legal aspects relating to allegations of "impropriety" in the demand and fraud, especially par 13 *et seq*, are intentionally omitted for purposes of this discussion.

[96] par 5 (alterations, emphasis and omission by me).

[97] par 6 (added emphasis by me).

contractor had been cancelled, attached a copy of the cancellation letter and the guarantee, and demanded payment from the guarantor.[98] Absa Insurance, however, rejected the demand on the grounds[99] that

> "the [University] failed to comply with the terms of the guarantee in making its demand, because the principal agent (LMC Project Management) made the demand and not the employer [the University] as stipulated in the guarantee."[100]

The University took to the courts to enforce the guarantee. Although it is not mentioned in the judgment, one can probably assume that the guarantee had expired shortly after the demand by the agent as otherwise the beneficiary could have easily rectified the initial potentially defective demand and substituted it with one in accordance with the guarantor's understanding of conformity.

Fourie J was faced with the guarantor's plea that strict compliance, just like in the law of letters of credits, ought to apply to demand guarantees.[101] With regard to clause 5 of the guarantee,[102] Absa Insurance argued that the demand must be made by the beneficiary itself in order to be compliant – the demand it received, however, had been made by the principal agent.[103] The demand, as pointed out by the court, was written on the letterhead of the principal agent and signed by a representative of the principal agent.[104] The last paragraph of the demand read as follows:

> "The University of the Western Cape (Employer) herewith notifies the Guarantor that the [building contract] with [the contractor] has been terminated due to the Contractor's default and the Construction Guarantee is called up in terms of Clause 5.1 of the Guarantee.'"[105]

Accordingly, so the guarantor argued, the beneficiary had not complied strictly with the terms of the guarantee and was not entitled to payment.[106] On proper assessment, the guarantor's defence was based on the principle of strict compliance and the fact that the demand of an agent of the beneficiary could not meet this test. Fourie J explored the law of agency and the

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[98] par 3.

[99] As was mentioned, the other aspects of the guarantor's pleaded defence are left out in this case discussion.

[100] par 4 (per Fourie J).

[101] par 7.

[102] See above.

[103] par 8.

[104] par 9.

[105] par 9 (insertions and alterations by me).

[106] par 8.

requirements of compliance applicable to demand guarantees. After confirming that when drafting the letter of demand, LMC Project Management was "acting, not in its own name, but as the representative of the applicant",[107] the court stated: "The issue is therefore whether performance by a representative can be regarded as strict compliance with the term of the guarantee."[108] The discussion continued as follows:

> "Representation or agency is not only a well-known legal notion, but is also generally accepted by the business community and applied in the commercial world. Usually it can be applied in relation to any lawful act which the principal himself can perform. Such acts, when properly performed, are *ipso iure* the acts of the principal […]. However, there are, as usual, a few exceptions, for instance where the law requires performance by a specified person (*Potchefstroom Stadsraad v Kotze* 1960 (3) SA 616 (A)); where performance is of such a personal nature that it can be inferred the other party would require and be entitled to personal performance; and when performance by an agent or representative is by agreement excluded, either expressly or by necessary implication (cf Christie's *Law of Contract in South Africa*, 6 Ed p 422 and Kerr, *The Principles of the Law of Contract*, 6 Ed, p 520)."[109]

The court, in applying these principles to the facts of this case, held that the performance by the employer as stipulated in clause 5 was not "of such a personal nature that the guarantor may insist on personal performance", or that representation was prohibited or that performance by a specific person was required, or that any such term should be inferred or implied into the guarantee.[110]

In order to address the noticeable difference in clause 5 ("first written demand from *the Employer*") and the clause captured on the last page of the guarantee ("return of this original Guarantee by the *Employer* or the *Employer's duly authorised agent*"), Fourie J added:

> "The note at the end of the guarantee referring to the 'Employer's duly authorised agent' relates to the return of the original guarantee before payment will be made. The intention was, so it appears to me, to ensure the return of the original guarantee before any payment will be made and not to authorise representation only in this instance."[111]

The demand was accordingly found to be conforming on the basis that "the act of representation should be regarded as the act of the principal as if it had been performed by the principal itself".[112]

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[107] par 10.

[108] par 10. Regarding the question of the state of South African law and its stance on the applicable level of required strictness of compliance in demand guarantees, see par 6.2.5 above.

[109] par 11 (omission by me, some italics added).

[110] par 12.

[111] par 12.

[112] par 12.

It is suggested that this decision warrants both positive and negative criticism. On the positive side it has settled the issue of agency and brought legal certainty to demands presented by representatives. On the negative side, however, the court failed to provide clarity as to whether and if so to what extent the principle of strict compliance formed part of the law of demand guarantees.[113] Moreover, the obvious textual difference in the two clauses under consideration (clause 5 – "first written demand from *the Employer*", and the clause on the last page of the guarantee – "return of this original Guarantee by the *Employer* or the *Employer's duly authorised agent*"), deserved greater attention. While it is clear, as pointed out by the court, that the returning of the guarantee reduces the danger of multiple demands,[114] the interpretational principle of *argumentum a contrario* – that representation and agency was impliedly *disallowed* in all matters which went beyond the mere return of the guarantee – was left unaddressed.

The *Oberlandesgericht Munich* and *University of the Western Cape v ABSA Insurance Company Ltd* cases were concerned with demands submitted by agents. In the case of *Maridive and Oil Services (SAE) v CNA Insurance Company (Europe) Ltd*[115] the question was somewhat different. The party submitting the demand argued that it was the true beneficiary and that the named beneficiary was merely its agent. It is probably fair to state in general that the court favoured a rather strict approach in terms of which it would be difficult for a party to submit a valid claim on the guarantee in which it was not indicated as the beneficiary.[116]

The guarantee, *in casu*, listed a certain "Club" as the beneficiary. When a party identified as "Maridive" made a demand and argued that the Club was in fact its legal representative and agent, making Maridive the true yet unnamed beneficiary and thus entitled to lodge a claim, the court disagreed. Mance LJ held:

> "The argument of agency faces the difficulty that, in whatever capacity the *Club* entered into the [guarantee], its terms still require a demand by and payment to the [beneficiary], defined as the *Club*. The demand dated 4th May 1999 was in contrast a demand by *Maridive* for payment to *Maridive*. Even if *Maridive* was a party to the [guarantee] through its 'legal […] representative' the *Club* […], still a

[113] Although it appears from par 10 that the court impliedly accepts the principle, this issue could have been clarified better.

[114] For a discussion of multiple/partial demands and the return of the original guarantee, see par 6.4 below.

[115] n 89.

[116] See the reasoning par 9-11 per Mance LJ, with Chadwick and Ward LJJ concurring (par 51 and 63, respectively).

> contractually valid demand could only be made by the *Club* as [beneficiary] for payment to the *Club* in the same capacity."[117]

It is submitted, however, that it would be prudent to exercise caution when relying on the decision in *Maridive and Oil Services (SAE) v CNA Insurance Company (Europe) Ltd* to reject a demand under a guarantee, as the facts of this case are rather unusual. The more common situation in which a party submits a claim on behalf of the named beneficiary, with a request to make payment directly to the beneficiary, was not before the court.

6.3.3 The beneficiary: legal succession and the rights under the demand guarantee

The question considered in this paragraph is whether the legal successor of the named beneficiary is entitled to claim under a guarantee. Some demand guarantees make express provisions[118] for this eventuality in which case there is no uncertainty. This issue is also dealt with in rules 6.11-6.14 of the ISP98, which set out the requirements for the successor's entitlement. Essentially, the successor must present, in addition to the documents prescribed in the guarantee, documentary proof of his succession and authorisation.[119]

The question arises, however, what the position is should the ISP98 not be applicable and the guarantee itself is silent on the issue. In such a situation it is conceivable that the applicant and guarantor may attempt to resist or prevent payment.

In *GKN Contractors Ltd v Lloyds Bank plc*,[120] the court was confronted by a demand-guarantee transaction in which certain legal changes to the employer of a construction and service contract in Iraq had occurred. The Iraqi entity, which was also named in the guarantee as the beneficiary, had been dissolved and its obligations and responsibilities re-established by way of legislation and a later ministerial order under a different department and name,

[117] par 11 (omissions and alterations by me).

[118] Graf von Westphalen and Zöchling-Jud (n 46) 661 par 31. See also par 8.3 below.

[119] ISP98 rule 6.12 provides for documentary proof relating to the following: "a) that the claimed successor is the survivor of a merger, consolidation, or similar action of a corporation, limited liability company, or other similar organization; (b) that the claimed successor is authorized or appointed to act on behalf of the named beneficiary or its estate because of an insolvency proceeding; (c) that the claimed successor is authorized or appointed to act on behalf of the named beneficiary because of death or incapacity; or (d) that the name of the named beneficiary has been changed to that of the claimed successor".

[120] n 12.

making it a "statutory universal successor" to the previous party.[121] When a demand was eventually made under the guarantee (and on the linked counter-guarantee), the applicant (GKN Contractors) attempted to enjoin both guarantor and counter-guarantor from accommodating the demand. The argument advanced was that the named beneficiary had not lodged the claim, but a different entity which was not captured in the guarantee (the newly established successor). Parker LJ explained that the "case on behalf of the GKNC was based solely on the identity of the party making the demand […]", while other issues were to be disregarded due to procedural preclusion.[122] He continued to examine the facts of the case, and English authorities relating to demand guarantees, and concluded that the demand was indeed made "by somebody who was not the named beneficiary".[123] On the other hand, all parties involved, including the applicant GKN Contractors, had negotiated before the call on the guarantee with the new entity which was later to make the demand, fully aware of the different legal personality and name, and without raising any concerns or objections.[124]

The court approached the question whether there were any grounds for the applicant to be granted an injunction against the guarantor to honour the guarantee and also call-up the counter-guarantee, through the prism of *fraud*.[125] Parker LJ held:

> "I have *no doubt* whatever that the evidence before this court is *quite insufficient to establish a case based on the fraud exception* sufficiently strong to enable this court to grant an injunction. The matter was plainly one of considerable confusion. The state of the confusion is revealed by the fact that parties in Iraq themselves do not appear to have known from one moment to another what was the precise effect of the ministerial order.
>
> There is conflicting evidence from Iraqi lawyers as to the effect of the ministerial order, and indeed of the demand itself; and to suggest in such circumstances that the *only reasonable inference* to be drawn is that the demand is *fraudulent* is in my view *quite impossible*. Accordingly, the fraud exception itself can afford no assistance to GKNC."[126]

On reading this very passage of the judgment, one would be convinced that Parker LJ was about to dismiss the case based on his observation thus far. Surprisingly, and somewhat confusingly it is respectfully suggested, he nevertheless continued with his discussion of fraud:

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[121] See 54-55. For purposes of the present discussion certain features of the case (legal and factual) have been simplified.

[122] 62 (alteration by me).

[123] 63.

[124] 59 (for example).

[125] See the elaborations at 62-65 of the judgment.

[126] 64 (emphasis is mine).

> "The only question which arises is whether the fact that in this case *the demand did not tally with the terms of the document itself*, in that it was made *by a party not named, extends the ambit of the [fraud] exception*. In my view it is arguable that it does, and that is all that is necessary for present purposes. I take the view that it is arguable that on that ground the demand [on the guarantee] was not a good demand. It is also arguable that in the present state of knowledge, Lloyd's demand on GKNC [for reimbursement] was not a good demand. Therefore, in my view the situation has arisen that GKNC surmount the first hurdle; they do show an arguable case that, if Lloyds [as counter-guarantor] were to pay or [the guarantor] were to pay, one would be guilty of a breach of contract and the other would be guilty of a tortious act. That, however, by no means ends the matter."[127]

The applicant GKN Contractors was eventually denied the injunction preventing the payments under the guarantee(s). As the counter-guarantor (Lloyds Bank) was in any case solvent enough to return money they might unfairly have debited from the applicant's account (GKN Contractors), Parker LJ refused the application for judicial intervention. No irreparable harm, a prerequisite in English law for the injunction sought, would befall the applicant should the guarantee(s) be honoured wrongly.[128] From this judgment it is not entirely clear whether (non)conformity and fraud were always treated as separate issues. Because the court unfortunately did not clearly distinguish between *fraud* on the one hand, and *non-conformity of the demand* on the other hand, no sufficient and strong guidance can be derived regarding the issue of the identity and identification of the beneficiary and documentary compliance.

In the American case of *American Bell International v Islamic Republic of Iran*,[129] a New York District Court was petitioned to grant an injunction against payments under a counter-guarantee. Before the Islamic revolution in Iran, the applicant Bell had concluded an agreement for consulting and installation of telecommunication infrastructure with the Iranian government and received substantial cash advances for services to be rendered. On Bell's behest a local Iranian bank (Bank Iranshahr) had issued a demand guarantee securing the repayment of the advances, and in turn received a counter-guarantee by an American entity (Manufacturers Hanover Trust Company) to be reimbursed should the guarantee be called upon. The guarantee was issued in favour of the "Imperial Government of Iran", which was in power before the revolutionary events. After the Islamic government was established, the guarantee was called up. Bell tried to have Manufacturers restrained from meeting the request based on the contention that the call was not in conformity with the formal requirements in that it was not the prescribed beneficiary that was demanding payment, but a new

[127] 64 (alterations and emphasis by me).

[128] 62-65.

[129] 474 F Supp 420 (1979) (District Court, SD New York).

government department which was not the true beneficiary under the guarantee. The court held per District Judge MacMahon:

> "As to nonconformity, the […] demand by Bank Iranshahr is identical to the terms of the Manufacturers Letter of Credit in every respect except one: it names as payee the '*Government of Iran Ministry of Defense, Successor to the Imperial Government of Iran Ministry of War*' rather than the '*Imperial Government of Iran Ministry of War*.'"[130]

He continued to evaluate the textual divergence and stated:

> "Nevertheless, we deem it *less than probable* that a court, upon a full trial, would find *nonconformity in the instant case*.
>
> At the outset, we notice, and the parties agree, that the United States now recognizes the present Government of Iran as the legal successor to the Imperial Government of Iran. That recognition is binding on American Courts."[131]

Additionally, the judge explained with regards to the change in government and its potential effect on contractual agreements and obligations that "American courts have traditionally viewed contract rights as vesting not in any particular government but in the state of which that government is an agent."[132] In conclusion, he decided:

> "Accordingly, the Government of Iran is the successor to the Imperial Government under the Letter of Guaranty. As legal successor, the Government of Iran may properly demand payment even though the terms of the Letter of Guaranty only provide for payment to the Government of Iran's predecessor [authorities cited]."[133]

Moreover, the court eventually held:

> "Finally, an opposite answer to the narrow question of conformity would not only elevate *form over substance*, but would render financial arrangements and undertakings worldwide wholly subject to the vicissitudes of political power. A nonviolent, unanimous transformation of the form of government, or, as this case shows, the mere change of the name of a government agency, would be enough to warrant an issuer's refusal to honor a demand. *We cannot suppose such uncertainty and opportunity for chicanery to be the purpose of the requirement of strict conformity*."[134]

The District Court therefore denied Bell's application against Manufacturers for an injunction based on the argument of documentary non-conformity, and deemed the discrepancy between named beneficiary and the entity actually demanding payment irrelevant. In this regard the

[130] 423 (omission and emphasis by me).

[131] 423 (emphasis by me).

[132] 423.

[133] 423 (omission and alteration by me).

[134] 424 (emphasis is mine).

American Bell case must be noted as a remarkable judgment. Mugasha[135] criticised the decision due to the "flexibility" introduced by the court:

> "This flexibility, however, is not without difficulties for banks because it requires them to make decisions concerning payment on considerations beyond letter of credit law, such as the doctrine of state succession, and the law of business associations (corporations and partnerships law). […] The bank which is not satisfied that the entity demanding payment is legally the beneficiary's successor would be advised to defer payment and seek court direction."

Also, the political circumstances at that particular time must be appreciated. The American Bell case was decided before the so-called "Iranian hostage crisis of 1979-1981", which purportedly influenced the courts' attitude in the United States shortly thereafter.[136] The case, moreover, is American and thus not binding on English or South African courts.

Regarding the position in South African and German law, neither case law nor legal commentary in point seem to be available. It is suggested, therefore, that the ordinary rules of legal succession and merger apply. This would mean that the entity succeeding, or merging with, the original beneficiary would be able to assume all rights previously vested in the beneficiary – including the rights relating to the guarantee. In order to make a compliant demand the legal successor of the beneficiary, therefore, should be required to satisfy all documentary conditions of the guarantee and, additionally, prove its legal position as successor of the original beneficiary. To complement the documentary nature of demand guarantees the successor should, preferably, furnish proof which enables a guarantor to ascertain the entity's entitlement with reference to documents alone. No further investigation should be necessary to establish the entitlement of the merged or succeeding entity.

6.3.4 Identity discrepancies: demand guarantee and the underlying contract

The discrepant identification of parties in the documents relating to the underlying construction contract and the guarantee can be problematic. It may lead to the questioning of the beneficiary's entitlement to claim under the guarantee or question of the very validity of the guarantee. The manner in which mistaken identification of the beneficiary (the employer in the construction contract) in the first place, and the applicant (the original debtor in the

[135] *The Law of Letters of Credit and Bank Guarantees* (2003) 116 (omission by me). See also the interesting reference in his (n 68) to the UCC Revised Article 5, section 5-113, dealing with beneficiary succession under American law.

[136] See Bertrams (n 28) 444-445; and Zimmett "Standby letters of credit in the Iran litigation: two hundred problems in search of a solution" 1984 *Law and Policy in International Business* 927 (especially 929 *et seq*).

underlying contract) in the second place, has been dealt with in South African, German and English law is considered below followed by some concluding remarks.

6.3.4.1 Discrepancies: beneficiary and employer

The *Dormell Properties* case[137] has already been considered in a different context above.[138] A further aspect of the case relates to the identification of the beneficiary in the guarantee.

In order to develop a shopping centre, Dormell engaged the building contractor Synthesis. In their building contract, Dormell was indicated as the employer and identified as "Dormell Properties 282 (Pty) Ltd".[139] A few days prior to this, however, Dormell's status changed to that of a close corporation (Dormell Properties 282 CC).[140] The construction guarantee identified the beneficiary as "Dormell Properties 282 (Pty) Ltd".[141] When the guarantee was eventually called up by Dormell (as close corporation) the guarantor, Renasa, refused to pay, among others, on the grounds that Dormell Properties 282 CC was not the formal and true beneficiary under the guarantee.[142] Dormell, in response, applied for the rectification of the guarantee on the basis that all three parties always intended that the guarantee was to be in favour of the employer.[143]

The South Gauteng High Court refused the application, and Dormell appealed to the Supreme Court of Appeal, *inter alia* on the rectification issue.[144] Delivering the decision for the majority of judges, Bertelsmann AJA stated:

> "The court below dismissed Dormell's prayer for rectification of the guarantee to reflect it as the employer, on the ground that Dormell was unable to show that there was either common intention or an antecedent agreement between the parties that was not correctly reduced to writing as a result of a common error. […]
>
> It is correct that [Dormell] and [Renasa] did not agree upon the identity of the employer prior to signing of any of the three guarantees. Renasa was informed by a broker of the particulars of the party

[137] *Dormell Properties 282 CC v Renasa Insurance Co Ltd* 2011 (1) SA 70 (SCA).

[138] For that aspect of *Dormell Properties*, see par 5.3.2 above.

[139] par 6.

[140] par 7.

[141] par 10.

[142] par 16.

[143] par 17.

[144] See par 24.

> in whose favour the guarantee had to be issued. These instructions reflected the company's particulars [that is Dormell Properties 282 (Pty) Ltd]. The insurer remained unaware of [Dormell Properties 282 CC's] existence until the building contract was cancelled."[145]

Accordingly, the Supreme Court of Appeal was unable to find an antecedent agreement between Dormell and Renasa regarding the precise identity of the employer of the underlying building contract. With reference to case law,[146] however, the judge was able to show that South African law does not necessarily require a precursory, prior agreement in order to allow for a rectification in such circumstances:

> "The absence of an antecedent agreement does not in itself preclude rectification of a written agreement that does not correctly reflect the parties' intentions.
>
> […] The facts of this matter clearly demonstrate that Renasa was more concerned with obtaining sufficient security from Synthesis, to back up the guarantee, than with the terms of the building contract, or the exact description of the employer. There is merit in Dormell's argument that all three parties, and in particular Renasa and Dormell, intended to secure the employer's position. The guarantee should therefore have been rectified to reflect that intention."[147]

Cloete JA in his minority judgment[148] agreed, holding as follows:

> "The common continuing intention of the appellant [Dormell], the beneficiary under the guarantee, the second respondent [Synthesis], that procured the guarantee, and the first respondent [Renasa], that gave the guarantee, was quite obviously that the guarantee should be issued in favour of *whomever was the employer in terms of the building contract – not* who was *defined* as the employer, but who was *in fact* the employer."[149]

He continued to explain the mistakes the different parties made due to their unawareness of Dormell's legal conversion from a company to a close corporation and the importance thereof:

> "The mistake that [Renasa] made was that, contrary to its belief, the Dormell company was not the employer as (unbeknown to Renasa) the Dormell company had been converted to a close corporation, the appellant. The mistake made by the appellant and the second respondent [Synthesis] was that they thought the appellant's conversion into a close corporation was irrelevant. But all parties concerned intended that the guarantee should be in favour of the employer under the building contract: and the appellant [Dormell Properties 282 CC] was in fact the employer. That suffices for rectification: [reference to *Meyer v Merchants' Trust Ltd* 1942 AD 244]."[150]

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[145] par 32-33 (insertions, omissions and alterations by me).

[146] Bertelsmann AJA (par 35-36) explored both *Meyer v Merchants' Trust Ltd* 1942 AD 244 as well as the more recent case of *Soil Fumigation Services Lowveld CC v Chemfit Technical Products (Pty) Ltd* [2004] 2 All SA 366.

[147] par 36-37 (omission by me).

[148] Cloete JA disagreed on another point of law with the majority, which was elaborated on in 5.3.2 *et seq* above.

[149] per Cloete JA at 52 (insertions and added emphasis by me).

[150] par 52 (insertions by me).

The judges of the Supreme Court of Appeal were therefore, essentially, in agreement[151] that Dormell, despite the conversion into a close corporation, and the misleading identification in the guarantee (Dormell Properties 282 (Pty) Ltd), was in fact the true beneficiary. The formal discrepancy was overcome by recourse to the parties' common intention of securing the employer's rights. Since Dormell – as close corporation – was indeed the actual employer, Dormell should have been granted the rectification of the guarantee in order to erase any doubts as to its entitlement to claim once the guarantee's documentary requirements were met. The normal rules of rectification were employed to ensure that the true intention of the parties prevailed rather than the formal identification of the beneficiary on the guarantee. It should be noted that if the rectification application had not succeeded, the identity issue would have been a problem and Dormell would not have been able to claim on the guarantee.

In an interesting German case, the *Landgericht Dortmund*[152] had to decide on an appeal against an urgent interdict relating to a demand-guarantee transaction. A German company had entered into a contract with the "Imperial Iranian Government – Port and Shipping Organization (PSO)". According to this agreement, the German company was to manufacture, deliver and maintain seven forklift trucks. To secure its obligation, the German party was to procure a demand guarantee in favour of PSO. It instructed its own local German bank to approach an Iranian bank to do so. Subsequently, the Iranian bank issued a demand guarantee and was given a counter-guarantee by the German bank. The guarantee executed by the Iranian bank, however, was *delivered to PSO* but promised to secure a contract between the German company and the *Imperial Iranian Navy*. Although the forklift contract was mentioned in the guarantee, it must be emphasised that PSO and not the Imperial Iranian Navy was the buyer. Eventually, the Iranian bank called up the counter-guarantee. The German company obtained an interim injunction against its local bank, the counter-guarantor, enjoining it from paying out to the Iranian bank. The *Landgericht Dortmund*, on hearing the appeal, ascertained that the Iranian bank had indeed ignored the instructions to issue a guarantee in favour of the buyer, PSO, and had instead named the Imperial Iranian Navy as the beneficiary. This was in violation of the agreement between the

[151] Hugo "Documentary credits and independent guarantees" 2011 *Annual Banking Law Update* 116 125.

[152] LG Dortmund 1981 *WM* 280. While concerning a different commercial context, the legal principles emanating from this case are equally applicable to a construction context.

two banks and, the court held, the demand made by the Iranian bank was non-conforming.[153] Therefore no liability arose under the counter-guarantee.[154]

Accordingly, the court assigned crucial relevance to the discrepancy between the named beneficiary and the identity of the buyer in terms of the underlying contract; the appeal for the lifting of the interim injunction was rejected.

The two cases, *Dormell Properties* from South Africa, and *Landgericht Dortmund* from Germany, emphasise the different level of importance which the judges attributed to the precise identification and coinciding capturing of the parties' details in the documents. While *Dormell Properties* was able to overcome the discrepancies relating to the company (Pty Ltd) and the close corporation (CC), the German court denied payment on the basis, among others, that the Iranian guarantor had ignored instructions by the counter-guarantor and had made a non-conforming demand.

6.3.4.2 Discrepancies: applicant and original debtor

In the English case of *Meritz Fire and Marine Insurance v Jan de Nul NV*,[155] the court had to decide an appeal on a dispute which involved demand guarantees and changes to the legal identity of the original debtor of the underlying contract. When a Korean shipyard, HWS, entered into three separate agreements to build and deliver ships to two different parties (the buyers),[156] HWS was required to procure specific guarantees to secure advance payments made by the buyers. These repayment guarantees, payable on demand,[157] were issued by Meritz on behest of the applicant HWS in favour of the buyers. The money under the

[153] The court held: "Die gegebenen Anhaltspunkte reichen nicht aus, eine ordnungsgemäße Inanspruchnahme der Verfügungsbeklagten aus einer Garantie mit hinreichender Sicherheit festzustellen, die diese aufgrund des Geschäftsbesorgungsvertrages mit der Verfügungsklägerin erteilt hat" (282).

[154] Moreover, the court deemed the demand under the original guarantee to be abusive in any event, and therefore invalid due to the defence of *Rechtsmissbrauch* (282-283). See the previous case comment in par 5.7 above.

[155] [2011] EWCA Civ 827.

[156] The court mostly referred to the two parties collectively as the buyers due to the almost identical shipbuilding and similar guarantee contracts, and the corresponding legal issues arising therefrom.

[157] The legal construction of these guarantees became a point of contention between the parties, but the Court of Appeal eventually confirmed the on-demand nature in its judgment. In order to highlight the legal issue most relevant to the issue at hand (the identity of the original debtor of the underlying obligation), this case discussion omits the issue of legal differentiation between on-demand an accessory, secondary guarantees (suretyship contracts).

guarantees was stipulated to be payable upon written demand stating that the shipbuilding contracts had been cancelled and that HWS failed to repay the cash advances which the buyers had granted.[158] Through a choice-of-law clause, English law governed the guarantees.[159]

Subsequent to the formation of the underlying shipbuilding contracts, the payment of the cash advances to HWS by the buyers and the issuance of the demand guarantees by Meritz, the shipbuilder HWS essentially merged with another company and was renamed Buyoung.[160] The buyers and the guarantor Meritz were at some stage informed of the merger and that all rights and obligations under the shipbuilding contracts were now vested in Buyoung.[161] The original shipbuilder HWS was dissolved. During a later restructuring phase, Buyoung decided to establish a new company (Asia Heavy) and have it run the shipbuilding business, and accordingly transferred the contracts with the buyers yet again to Asia Heavy.[162] Finally, Asia Heavy therefore became the builder under the contracts with the buyers. When faced with delays and other complications, the buyers cancelled the shipbuilding contracts and demanded return of the cash advances from Asia Heavy.[163] When it failed to pay they turned to Meritz as the guarantor and made calls on the repayment guarantees. Before the Court of Appeal, all parties agreed that HWS was succeeded by Buyoung, and Buyoung later by Asia Heavy, which meant that Asia Heavy was now the responsible builder under the original shipbuilding contracts.[164] When faced with the demands on the guarantees, Meritz refused payment and argued that it never intended to secure a repayment obligation by a company other than HWS.[165] Therefore, Longmore LJ identified the "main focus of the argument" to consist of

[158] Certain features of the guarantees are left out (for instance the provisions dealing with possible referral of the underlying disputes to arbitration), as they do not contribute to the present discussion.

[159] See the finding by Beatson J in the judgment of first instance, *Meritz Fire and Marine Insurance Co Ltd v Jan de Nul NV* [2010] EWHC 3362 (Comm) (par 12 and 84). This aspect was not contested by either party and was not subject to the subsequent appeal proceedings.

[160] par 6.

[161] par 6.

[162] par 7.

[163] See par 8 of the judgment for a more detailed account.

[164] See the explanations in par 9-10 (Longmore LJ).

[165] As was explained above, the argument that the guarantees amounted merely to contracts of accessory nature is excluded from the present discussion.

> "unsurprisingly, […] the precise terms of the [guarantees] and the effect of the novation which occurred […] as a result of the transfer of the rights and obligations under the shipbuilding contracts first to Buyoung and then to Asia Heavy."[166]

On behalf of Meritz the following assertions were made at trial:

> "i) On the true construction of the [guarantees], Meritz had guaranteed the obligation of HWS to make the repayment and not the obligation of anyone else. Once the obligation of HWS had disappeared (whether by transfer to Buyoung or for any other reason), the [guarantees] no longer had any application;
>
> ii) No demand in conformity with clause 17 [termination clause] of the shipbuilding contract could be made, as required by paragraph 4 of the [guarantees], once the Builder was no longer HWS but Asia Heavy […]."[167]

Clause 4 of the guarantees read as follows:

> "The Buyer's demand for payment under this Advance Payment Guarantee (Letter of Guarantee) is payable upon our receipt of the Buyer's signed statement certifying that the Buyer's demand for refund is made in conformity with Clause 17 of the Contract and that *the Builder has failed to make the refund*."[168]

The Buyers, on the other hand, responded by arguing that:

> "On the true construction of the [guarantees], Meritz promised to repay the sums advanced if HWS did not. HWS had not paid and had therefore failed to pay within the meaning of paragraphs 2 and 4 of the [guarantees] […]."[169]

Longmore LJ, with Etherton and Laws LJJ concurring,[170] deliberated on the dispute and delivered the decision. Regarding the change in the identity of the original debtor of the underlying shipbuilding contract, and possible ramifications for the demand guarantee, the court held:

> "It is fair to say that a novation of the shipbuilding contract by operation of law does give rise to problems of construction of the [guarantees] which inevitably do, to some extent, depend on the existence of an underlying contract. But so could other events such as a frustration of the underlying contract or the dissolution of the shipbuilding company. I do not think it could be intended that the [guarantees] would become a dead letter in either of those events unless the wording to that effect were clear; any beneficiary would expect that, in the latter events the guarantee would be available in respect of sums already paid to the Builder.
>
> There is, on the other hand, much to be said for Meritz's submission that they took on the risk of HWS's defaults not the defaults of any persons who might be their successors, whose financial integrity or business acumen they would not have previously assessed. As against that there is the

[166] par 19 (omissions and insertions by me).

[167] par 20 (alterations by me).

[168] par 14 of the judgment (emphasis is mine).

[169] par 21 (omission and alterations added by me).

[170] par 32 and 33, respectively.

> finding [that Meritz could have objected to the transfer of the shipbuilding contract]. But they did not take that opportunity.[171]

Thus, the judges acknowledged that there is in fact a *commercial nexus* between the underlying contract and the demand guarantees, notwithstanding the guarantees' *legal independence and autonomy*. Under Korean law, the law applicable to the merger and restructuring of the companies and the transfer and novation of the underlying shipbuilding contracts,[172] Meritz as concerned party could have raised objections against the changes to the shipbuilders changing identity. However, Meritz chose not to do so. The court continued:

> "The Buyers did make advance payments; they stated that they had terminated the contracts in accordance with clause 17 of those contracts […] so they were entitled to a refund of the advance payments; in the absence of that refund, the repayment has to be made by the guarantors. [The Buyers] submitted that the [guarantees] were intended to operate on the basis that no refund had occurred not on the basis that the Builder had failed to make the refunds when it was obliged to do so. On the true construction of the [guarantees] as a whole, I agree with that submission."
>
> […] But since as a matter of fact no refund has been made it is, in any event, no abuse of language to say that the Builder has failed to make the refund. It may be that in the light of the novation HWS was not liable to make the refund but Asia Heavy was; it may be that in the light of the fact that HWS was dissolved […], HWS cannot make the refund. But neither of those facts matters. It has still "failed to make the refund" as envisaged by [the guarantees]."[173]

In conclusion, the English court sided with the arguments by the buyers and ruled the calls on the demand guarantees to be valid and enforceable. The judges accepted the fact that indeed the identity of the debtor of the underlying contract had changed at least twice (from HWS to Buyoung and finally to Asia Heavy), but regarded it as irrelevant in relation to the call on the guarantees. Hence, the changes in the identity of the original debtor under the shipbuilding agreements could not be used as a defence by the guarantor to rid itself of the obligation under the repayment guarantee to compensate for the failure to return the cash advance. This decision showed a strong appreciation by the English courts for the principle of independence in demand-guarantee transactions, even though the principle itself was not expressly mentioned in the judgment. Furthermore, it is laudable that the Court of Appeal did not entertain the notion that the contract of mandate[174] between HWS as the applicant for the guarantees, and Meritz as the guarantor, could provide a valid defence against the

[171] par 23-24 (alterations by me).

[172] par 1, 9, 10 and 24 of the judgment.

[173] par 25-26 (omission and alterations by me).

[174] Regarding the details of the contract of mandate see par 5.

beneficiaries' claims for payment under the guarantees. In this contract of mandate it was stipulated that

> "without Meritz's consent, HWS should not merge or consolidate with another corporation, that there be no change in its ownership, and that named persons be maintained as officers of HWS during the period of the [guarantees]."[175]

Naturally, this contract was of legal relevance only between the applicant HWS and the guarantor Meritz. It is firmly established that such a restriction in the *contract of mandate* cannot be transposed onto the beneficiary-guarantor relationship, and neither can it afford the guarantor a defence *against the beneficiary* when it claims under the guarantee.[176] Lastly, it is submitted that this judgment developed and explained the English law in respect of changes to the underlying debtor and the effect on an abstract guarantee with sufficient clarity.

A related legal issue has enjoyed the attention of the South African Supreme Court of Appeal in *Lombard Insurance Co Ltd v City of Cape Town.*[177] In this case the City of Cape Town[178] called for the submission of tenders for engineering works in relation to a water treatment project. One of the responding parties, a joint venture between the two companies Labor Construction and SA Focus, won the tender and was required, *inter alia*, to submit a construction guarantee securing its diligent and due performance under the anticipated engineering contract.[179] Because Labor Construction had previously dealt with Lombard Insurance as a guarantor, it approached this insurer and applied for a guarantee.[180] Lombard Insurance issued such a guarantee in favour of the City of Cape Town. In the guarantee it was recorded

> "that Labor, referred to in the guarantee as 'the contractor', had entered or was about to enter into a contract with [the City of Cape Town] for the contract No WW38/99. [Lombard Insurance] undertook to pay the [guaranteed sum] in the event of Labor, inter alia, failing to proceed with and complete the works or being placed under provisional or final liquidation or judicial management."[181]

[175] par 5 (alteration by me).

[176] See par 3.3 above. Note, however, the discussion in chapter 7 below (especially in regard to German law).

[177] 2008 (2) SA 423 (SCA). See Kelly-Louw and Hugo (n 47) 77-79 par 2.3 for a case discussion.

[178] Note, that in the early stages it was actually the "Cape Metropolitan Council", the "predecessor in title" to the "City of Cape Town", who initiated the formation of the contractual relationship, at par 2. The apparent later change in identity of the Cape Metropolitan Council and the City of Cape Town, respectively, was not addressed in the judgment and therefore also left out at this present case discussion.

[179] par 2-3 of the judgment.

[180] par 4.

[181] par 5 (alterations and insertions by me).

The joint venture between Labor Construction and SA Focus in regard to the contract WW38/99 was formally concluded, with Labor Construction responsible for, *inter alia*, the procurement of the performance guarantee, and SA Focus supplying the managerial expertise and the construction workers.[182] This was followed by the formation of the civil engineering contract between the City of Cape Town and the joint venture.[183] Subsequently the joint venture began its work, but before completion Labor Construction was provisionally liquidated. The City of Cape Town called up the guarantee and demanded payment from Lombard Insurance. The guarantor, however, refused to honour the demand guarantee on the following basis:

> "At all times, we were under the impression that the [engineering] contract was to be concluded with [Labor Construction] and we were not aware of the fact that the contract was in fact to be concluded with the joint venture. This is borne out by the fact that our guarantee refers only to [Labor Construction]. In view of the fact that the contract was not awarded to [Labor Construction] but rather to a joint venture, it is our contention that we are not liable in terms of the guarantee."[184]

With Lombard Insurance challenging any liability under the guarantee, and its insistence that it merely intended to cover performance by Labor Construction, and not a joint venture entity unknown to it, Mhlantla AJA phrased the "main issue on appeal" to be "the proper interpretation of the guarantee. Simply put, what was the guarantee?"[185] To answer this question, she made reference to the exact wording of the instrument and scrutinised the text of the guarantee:

> "In my view, the grammatical and ordinary meaning of the language of the guarantee is clear and unambiguous. It is evident therefrom that [Lombard Insurance] guaranteed due performance by Labor, in the event of Labor being the contractor in a contract it concluded with [the City of Cape Town]. […] What the appellant guaranteed was the performance of the contractor's obligations. The contractor was defined as Labor. The guarantee envisages that 'the contractor' ie Labor, and (by implication) only Labor, would complete 'the works' defined as contract no WW38/99 – not that the works would be completed by another unnamed person. There can be no doubt that, on a proper interpretation, the guarantee covered Labor and not the joint venture.
>
> […] It is accordingly clear that the cause of action is based on a guarantee being claimable in the event that Labor concluded a contract with the respondent. The guarantee covered various eventualities provided the contract was between Labor and [City of Cape Town]. The contract was however concluded between [City of Cape Town] and the joint venture of which Labor was a partner."[186]

[182] par 6.

[183] par 7.

[184] par 7 (per Mhlantla AJA – alterations and insertions by me).

[185] par 11.

[186] par 15-16 (alterations and omissions by me).

The court's interpretation of the guarantee was accordingly that it intended to secure a contract between the City of Cape Town and Labor, and only a contract between these two parties. Hence the guarantee did not provide security for the contract under consideration in this case. The court addressed the arguments by the beneficiary and employer of the underlying engineering contract as follows:

> "It was submitted on behalf of the [City of Cape Town] that the only material requirement for [Lombard Insurance] to be liable in terms of the guarantee is that Labor must have entered into a contract with [the City of Cape Town] and that the capacity in which Labor contracted with [the City of Cape Town] is not relevant.
>
> […] This submission is, in my view, without merit. [Lombard Insurance] undertook to guarantee the obligations of 'the contractor' as defined, and not the obligations of a contracting party (whomsoever that might be) on whose behalf Labor would enter into the contract. It has to be borne in mind that the obligations of a partnership and those of the individual partners in their personal capacities are not, in the absence of an agreement, interchangeable."[187]

Lastly, the court investigated the objectives and intentions of the parties involved in the guarantee transaction to ascertain the ambit of the guarantee, and its potential scope of protection regarding the obligations under the engineering project. The court found in favour of the guarantor, Lombard Insurance:

> "It was never the intention of Labor and [Lombard Insurance] to extend the guarantee to cover Labor's performance as a partner in a joint venture. That would be going beyond the language of the guarantee.
>
> […] Even if it be accepted that the guarantee was ambiguous, in that it could as a matter of linguistic construction be interpreted to cover either Labor's obligations as a sole contractor or Labor's obligations even if it was not the sole contractor, the background circumstances show that this latter meaning could never have been intended by the parties: not by Labor, because its obligations to [the City of Cape Town] and to SA Focus were to obtain a guarantee for the obligations of both partners to the joint venture; not by the [Lombard Insurance], because the [Lombard Insurance] was unaware of the existence of SA Focus; and not by [the City of Cape Town] because it required a guarantee covering the obligations of the joint venture, not one of the partners in the joint venture.
>
> […] It is accordingly evident that [Lombard Insurance] did not undertake to secure the obligations of the joint venture or of Labor as a partner in a joint venture. The guarantee covered Labor as a sole entity. It follows therefore that [Lombard Insurance] cannot be held liable for the obligations of the joint venture."[188]

On interpretation of the guarantee itself the court accordingly found it did not cover the facts of the case and the guarantor was held not to be liable since the contractor in the underlying contract was not the contractor whose work was being guaranteed.

Although similar in some respects, the Meritz Fire and Lombard Insurance cases are clearly distinguishable. In Meritz Fire the guarantor clearly intended to provide a guarantee

[187] par 17-18 (alterations and omissions by me).

[188] par 19-21 (alterations and omissions by me).

relating to a contract between the original shipbuilder (HWS) and the beneficiary of the guarantee. The fact that the identity of the shipbuilder changed (twice) does not affect this aspect at all. In the Lombard Insurance case, however, the guarantor did not at any time intend to provide a guarantee relating to a contract between the beneficiary of the guarantee and the contractor – it intended to provide a guarantee for a different contract that was never concluded. It is submitted that both decisions are convincing and correct.

Finally, in this regard, it is of interest that in the case of *Basil Read v Nedbank Ltd*[189] an attempt was made to prevent payment of a guarantee in reliance on the *Lombard Insurance* case. In this case the court, on the return day of a *rule nisi* granted in the absence of one of the parties concerned, had to decide on the question whether payment of a demand guarantee could be interdicted on the basis of the contractor in the underlying contract being a different person than the applicant for the guarantee.[190] Although the applicant for the guarantees and the contractor in the underlying construction contract belonged to the same group of companies, they were nevertheless different and separate entities. Saldulker J (as she then was) summarised the arguments before the court as follows:

> "The applicant contends that the guarantees are *unenforceable* and should not be paid. The applicant states that there are issues raised […] that clearly indicate that it is not liable to make payments as demanded by the [employer/beneficiary], [party alleged fraud and defectiveness of the demand]; and that importantly *the applicant did not contract with the [employer/beneficiary] nor did it receive any payment from the [employer/beneficiary]. As a result the applicant contends that it is not liable to make payment as demanded by the [employer/beneficiary]*."[191]

In the following discussion she held:

> "The applicant alleges that the [employer/beneficiary] is not entitled to call upon the [guarantor] to pay the amounts claimed under the guarantees because of some dispute between the applicant's subsidiary [the contractor] and the [employer/beneficiary]. The applicant relies on the decision of *Lombard Insurance Company Ltd v City of Cape Town* 2008 (2) SA 423 (SCA) as authority for the proposition that because a contract was entered into between a subsidiary or associated company of the applicant and the [employer/beneficiary] and not the applicant itself, that the guarantee is invalid."[192]

This argument was rejected by the court which held that the *Lombard Insurance* case was distinguishable since in that case the guarantee clearly contemplated that Labor would be completing the works. In this (the *Basil Read*) case, however the guarantee contemplated that

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[189] [2012] ZAGPJHC 101.

[190] For a more detailed case discussion which relates to the additional legal issues decided by the court, see Hugo and Marxen "Documentary credits and independent guarantees" 2013 *Annual Banking Law Update* 25 25-28.

[191] par 23 (alterations, omissions and added emphasis by me).

[192] par 27 (alterations by me).

a company different from the applicant would complete the works. The application was accordingly dismissed.

It is submitted that the judgment is clearly correct. The contractor and applicant need not be the same person. The guarantor will often require security before issuing a guarantee.[193] If the contractor cannot provide the necessary security it is not unusual for another entity or person (such as a parent or sister company, or shareholders) to assume the role of the applicant, and provide the necessary security to the guarantor for the guarantee to be issued.

6.3.5 Identity of the parties: concluding remarks

Three main aspects regarding the identity of the parties and their proper identification in the context of guarantees have been examined above: (i) agency and representation, (ii) legal succession and rights under the guarantee, and (iii) identity discrepancies in respect of the guarantee and the underlying contract.

Agency and representation

Regarding agency and representation, the research has shown that agency and representation are generally accepted in a demand-guarantee transaction. The case law reviewed above points to some of the difficulties which may arise in relation thereto. Commentators have also applied their minds to this issue,[194] and scholars like Bertrams and Graf von Westphalen, for example, are in favour of allowing agents to lodge a demand on a guarantee, provided proper authorisation was given.[195] However, a particularly strong point is made by Mugasha in this regard:

> "From a practical angle […] the banks' letter of credit practice would become clogged if occasionally unnamed agents signed and presented documents. Banks would have to rummage through the beneficiaries' constitutions, memoranda of association and minutes of board meetings trying to ascertain who the agents are, in what circumstances they may sign for their principals and, indeed, whether the constitutions and memoranda under scrutiny are the current and authentic versions. It is

[193] See par 3.3 above.

[194] Graf von Westphalen and Zöchling-Jud (n 46) 155-160 par 103-115; Schütze and Edelmann *Bankgarantien* (2011) 37 par 8; Bertrams (n 28) 290-291; Mugasha (n 135) 117; and Rüßmann (n 46) 1831 par 4.

[195] Bertrams (n 28) 290-291; and Graf von Westphalen and Zöchling-Jud (n 46) 156 par 105 and 159 par 113.

> therefore argued that the practice of allowing agents to sign should be limited to the utmost possible extent."[196]

Although he advanced this argument in relation to agency in letters of credit, it is suggested that it is equally relevant to demand guarantees. Nevertheless, representation and agency *per se* seem to be acknowledged and appreciated internationally in independent payment obligations like letters of credits and demand guarantees,[197] without which proper security in construction could not be achieved.

Furthermore, one policy issue must be considered in this context of agency and representation: the one clear remedy available to an applicant or guarantor faced by a demand under a guarantee lies in the fraud exception. Allowing the demand to be made by an agent (as opposed to by the beneficiary) provides a degree of *insulation* to the beneficiary against allegations of fraud. It is suggested that this issue deserves attention. There are now two persons whose state of mind can play a role, namely the beneficiary and the agent. It is potentially possible, for example, that the agent may honestly believe that the beneficiary is entitled to call up the guarantee while the beneficiary positively knows it is not.

Finally, and on a fundamental level, it should be pointed out that allowing demands by agents may force guarantors to investigate the authority of such agents to sign and act on behalf of the actual beneficiary.[198] The determination whether a guarantee should be paid should be a simple matter capable of being dealt with, generally, on the presented documents alone. It is interesting to note that the ISP98 may require the statement of demand to bear the beneficiary's signature, thus invalidating an agent's demand in certain situations.[199]

[196] Mugasha (n 135) 117 (omission by me).

[197] For *demand guarantees*, see Schütze and Edelmann (n 194) 96-97 par 2; Graf von Westphalen and Zöchling-Jud (n 46) 156-161; and Schütze (n 92) 84 par II 2. For *letters of credit*, see Adodo *Letters of Credit the Law and Practice of Compliance* (2014) 101 par 4.06; and Ehrlich and Haas (n 46) 159 par 2/226. Although Adodo, Ehrlich and Haas discuss documentary letters of credit, their remarks should be seen as equally fitting in relation to demand guarantees.

[198] Bertrams (n 28) 290-291; and Mugasha (n 135) 117. Even though Mugasha expressly referred to letters of credit, his criticism should still be equally applicable to demand guarantees.

[199] ISP98 rule 4.17(c) reads: "If a standby requires a statement, certificate, or other recital of a default or other drawing event and does not specify content, the document complies if it contains: a. a representation to the effect that payment is due because a drawing event described in the standby has occurred; b. a date indicating when it was issued; and c. the *beneficiary's signature*." (emphasis added by me).

Legal succession

Changes to the beneficiary of a guarantee, for example by way of merger or legal succession, may give rise to the question as to who is entitled to submit a claim under the instrument. In the English case of *GKN Contractors Ltd v Lloyds Bank plc*, a reasonably strict approach was favoured by the court, and the entitlement of the (new) beneficiary was put into question.[200] On the other hand, in the American case of *American Bell International v Islamic Republic of Iran* it was suggested that changes relating to the structure and the name of the beneficiary, a governmental department, would not bar the new department from lodging a valid demand. It is, however, recommended to make clear provisions in the guarantee in order to either recognise or disallow any possible legal successors to exercise the rights of the original, previous beneficiary.[201] This is especially important for agreements which are subject to German or South African law, as no clear judicial guidance is available in either jurisdiction. Should the parties elect to make their guarantee transaction subject to the ISP98, then a successor is eligible to claim under the guarantee provided it submits documents indicating its authorisation.[202]

Identity discrepancies

The incorrect identification of the beneficiary (the employer in the construction contract), or the applicant (the original debtor in the underlying contract) has been examined from the position of South African, German and English law. It has emerged that absolute compliance is not always necessary regarding the proper identification of all parties. The intentions of the parties, or what is reasonably presumed to be their intended agreement, can overcome certain discrepancies in identification, and permit a valid demand. Parties in the construction industry, however, are well-advised to devote attention to the proper identification of all parties,[203] despite some evidence in case law that courts may show leniency regarding unintended formal discrepancy.

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[200] Note, however, that court relief was denied on the basis that no irreparable harm would be suffered if the injunction was not granted. According to the court the solvency of the opposing party was established so that, at a later stage, a legal remedy was available. See the discussion above, par 6.3.3.

[201] See par 8.3 below.

[202] ISP98 rule 6.11-6.14.

[203] See par 8.3 below.

The cases of *Dormell Properties* (South Africa) and *Landgericht Dortmund* (Germany) dealt with the precise identification and the coinciding capturing of the parties' details in the contract documents. The court in *Dormell Properties* was able to overcome the discrepancies relating to the company (Pty Ltd) and the close corporation (CC). The conversion of the beneficiary into a close corporation did not affect its rights under the guarantee which was issued in favour of the company. The court stated that the parties' common intentions indicated that the change was irrelevant. The *Landgericht*, on the other hand, stressed in the German case that the Iranian guarantor had disregarded instructions by the counter-guarantor and had made a non-compliant demand due to discrepancy in the identity of the beneficiary.

In the English case of *Meritz Fire and Marine Insurance v Jan de Nul NV*, a call on a demand guarantee was allowed despite changes to the identity of the underlying debtor due to merger and restructuring. The court found that the identity of the debtor of the underlying contract had changed, but regarded it as immaterial in relation to the claim on the guarantee. In *Lombard Insurance Co Ltd v City of Cape Town*, the South African Supreme Court of Appeal dismissed the claim on a guarantee. The guarantor was held not to be liable since the particular contractor in the underlying construction contract was not the contractor envisaged by the guarantor when issuing the guarantee. Finally, in *Basil Read v Nedbank Ltd* the South African High Court made clear that the contractor and the applicant need not be the same person, thereby accepting the occasional business practice in which a third party may act as the applicant for the guarantee.

6.4 Return of the original guarantee, partial and multiple demands

A demand guarantee often contains a clause obliging the beneficiary to return the guarantee with a demand or on expiry.[204] The return of the guarantee document can, however, in certain circumstances lead to problems. The "guarantee document is neither a commercial paper nor a negotiable instrument",[205] and, as stated in the UNCITRAL Convention[206] "in no case shall retention of any such document by the beneficiary after the right to demand payment ceases

[204] Schütze and Edelmann (n 194) 60; Ehrlich and Haas (n 46) 418 par 9/41; and Blesch and Lange *Bankgeschäfte mit Auslandsbezug* (2007) 175 par 578.

[205] Bertrams (n 28) 262 par 12-56/57.

[206] See par 3.2.3 above.

[…] preserve any rights of the beneficiary under the undertaking".[207] However, the refusal to return the original document can pose problems to the guarantor and the applicant, especially if the guarantee contains no expiry date,[208] or if the applicable law does not recognise or enforce such expiry dates.[209] The return of the original guarantee document can also lead to problems in the context of partial and multiple demands under the guarantee. If the guarantee is not returned together with the demand, this potentially opens the door for the beneficiary to make another or further demands under the same guarantee. Whether that is possible is a question that must be answered with reference to the terms of the guarantee itself. A *partial demand* is a demand for less than the maximum amount covered by the guarantee, with the consequence that the beneficiary may potentially be able to submit *multiple demands* under the same instrument.[210] The URDG 758, for example, expressly allows the beneficiary to submit partial and multiple demands, unless prohibited in the guarantee itself.[211] The ISP98 contains a similar provision.[212]

The return of the original guarantee in conjunction with multiple demands, however, can be problematic. This emerges clearly from the recent South African case of *Nedbank v Procprops*.[213] In this case, the Supreme Court of Appeal had to decide an appeal against a judgment of the North Gauteng High Court (Pretoria). In terms of a lease agreement between Procprops (the landlord) and Top CD (the lessee) for a period of ten years, the latter was required to furnish a demand guarantee in favour of Procprops to secure timely payment of the rent.[214] Nedbank issued a demand guarantee which stipulated that it would be available at

> "the landlord's first written demand, which written demand shall be accompanied by this original guarantee and which will state that the lessee had failed to comply with its obligations in respect of the

[207] UNCITRAL Convention Art11(2) (omission by me).

[208] Which, as explained, is very rare; see par 5.9 above.

[209] Bertrams (n 28) 254-259; Blesch and Lange (n 204) 155 par 544**;** Willmann *Die Bankgarantie im Bauwesen* (2013) 79 par 2.2.6.2; and Schütze and Edelmann (n 194) 59-60 par 2.4. See also par 5.9 above. The jurisdictions most relevant to this thesis, South Africa, England and Germany, all recognise and generally give effect to expiry clauses.

[210] Bridge *Benjamin's Sale of Goods* (2014) 2233 par 24-065-24-066.

[211] Art17.

[212] Rule 3.08.

[213] [2013] ZASCA 153 (20 November 2013).

[214] par 2 of the judgment.

> lease and that, accordingly, the amount of R313 845,53 [amount in words], or any lesser portion thereof, is now due and payable."[215]

The lease agreement provided for monthly rental payments by Top CD to Procprops in advance on the first day of each month.[216] Due to allegations of misrepresentations, breach of contract, cancellation and repudiation, Top CD only paid rent until December 2010 and left the office space during the course of that month. Procprops, however, insisted on rental payments until the end of December 2011. When no rent was received in January 2011, Procprops called up the guarantee by claiming R72 693,66. Van der Merwe JA stated:

> "This amount represented only the rental payable on 1 January 2011. The letter was accompanied by the original guarantee and concluded as follows: 'Could you also please consider the fact that this letter calls upon you to perform only partially in terms of the guarantee and accordingly our client's rights in respect thereof are not extinguished. Could you please in view thereof return the original guarantee to us to enable our client to call on the guarantee should it become necessary in future.'"[217]

Nedbank paid the amount claimed, but did not return the original guarantee. Procprops made two further demands in February and March respectively (each reflecting another month's rental) under the guarantee. This was accordingly a situation of multiple demands. Nedbank responded on 14 March 2011 in writing, denying any further liability as follows:

> "Please note that Nedbank did perform in terms of the guarantee in favour of your client, when we received your first written demand dated January 2011, accepted return of the original guarantee and duly paid the amount demanded. The guarantee has been cancelled and we are of the opinion that all obligations in terms thereof have been extinguished."[218]

Procprops, in turn, responded by a further demand in May for the amount of R 241 151.87, representing the difference between the full amount guaranteed and the amount already paid by Nedbank. When Nedbank failed to pay, Procprops commenced action in the North Gauteng High Court. Nedbank's plea to the claim was that its obligations under the guarantee had been discharged when it paid the first demand.[219]

The court of first instance gave judgment for Procprops, but granted leave to appeal to the SCA.[220] Citing several authoritative domestic cases,[221] Van der Merwe JA established the

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[215] par 3 (alteration by me, emphasis omitted).

[216] par 4.

[217] par 5.

[218] Cited after par 6 of the judgment.

[219] par 7.

[220] par 8.

[221] *Loomcraft Fabrics CC v Nedbank Ltd* (n 62); *Lombard Insurance Company Ltd v Landmark Holding (Pty) Ltd* (n 62); and *First Rand Bank v Brera* 2013 (5) SA 556 (SCA).

independent, on-demand nature of the guarantee in question.[222] He then identified the "central issue" to be "whether on a proper interpretation of the guarantee it provided for more than one payment by Nedbank".[223] Two arguments were advanced to support the notion that Nedbank was not obliged to accept more than one demand. They were stated as follows by the court:

> "The provision that the demand must be accompanied by the original guarantee strongly indicates that only one payment was envisaged. The purpose of this provision could not have been to provide Nedbank with an original guarantee or to have a record of its terms. In all likelihood, it already had one of its own. The purpose of the provision must therefore have been for Procprops to give up the security of the guarantee to ensure that it could not be presented for payment again."[224]

The second argument revolved around the expression "first demand" and its implications:

> "In addition, a meaning must be ascribed to the phrase 'first demand'. In my view the phrase excludes further demands. In context it therefore means that there could be no second or subsequent demand in terms of the guarantee. In my judgment the guarantee is unambiguous and clear."[225]

The court gave judgment in favour of Nedbank holding that:

> "Nedbank was only entitled and obliged to make payment of the amount of R313 845.53 or any lesser portion thereof upon receipt at its prescribed branch of Procprops' first written demand and the original guarantee. It follows that Nedbank's obligation in terms of the guarantee was discharged when it made payment of a lesser amount of R72 693.66 on 21 January 2011 pursuant to demand and the return of the guarantee."[226]

It is submitted that if, indeed, on proper construction of the guarantee, it allowed only one demand, the decision must be correct.[227] It is respectfully submitted, however, that the judicial reasoning is only partially convincing. To clarify, one must dissect the line of reasoning by the SCA. The court's first argument was based on the stipulation in the guarantee which required the original guarantee document to be attached to a demand and thus returned to the guarantor. This was indicative of the fact that the parties anticipated only one demand to be permissible.[228] Any further demand afterwards would have to be viewed as

[222] par 9.

[223] Both quotes taken from par 10 of the judgment.

[224] par 10 (per Van der Merwe JA).

[225] par 10.

[226] par 10.

[227] See also Hugo "Documentary credits and independent guarantees" 2014 *Annual Banking Law Update* 49 54.

[228] In a conference presentation it was therefore suggested that the "beneficiary ought to have claimed the full amount immediately, or, alternatively, should have waited until the amount of rental outstanding exceeded the guaranteed amount and then have claimed the full amount", Hugo (n 227) 54.

non-compliant,[229] as the documentary condition for payment – the submission of the original guarantee –could not be fulfilled (again). This explanation given by the SCA is convincing.

It is necessary, however, to comment also on the court's contention that the term "first demand" logically excluded any "further demands", or "second or subsequent demand[s]".[230] This interpretation, it is respectfully suggested, is unlikely to be correct.[231] The bank's promise to pay upon a "first demand" does not mean, viewed by itself, that only one demand is contemplated. Rather, the expression "first demand", in the realm of demand guarantees, expresses the ease of access to the guaranteed money, and underscores the liquidity function served by the instrument. The term "first demand" is used interchangeably in the industry, and could easily be replaced with, for example, "simple demand" or similar terms. The term "first demand", it is submitted, is not intended to restrict the number of permissible calls. It merely emphasises the simplicity of the demand, and the lack of actual proof necessary to trigger payment. This view of the SCA, unfortunately, has also subsequently led to this defence being raised by parties in later cases.[232]

Although there is no comparable case law in this regard in England or Germany, it is suggested that the question whether more than one demand is possible is a simple matter of interpreting the terms of the guarantee. However, it should be noted, that if the guarantee were to be subject to the URDG 758 or the ISP98, partial and multiple demands are allowed, unless the guarantee itself stipulates otherwise.[233]

6.5 Defences based on the terms of the guarantee: variable construction guarantees and retention money guarantees

The terms of the guarantee may also assist in resisting a demand in cases which involve guarantees known to the industry as "variable" or "adjustable" guarantees. These variable guarantees include a legal mechanism to adjust the liability of the guarantor under the

[229] Hugo (n 227) 54.

[230] par 10 (insertion by me).

[231] See also Hugo (n 227) 54. Unfortunately, his discussion of this case is reproduced incompletely in the conference reader, and breaks off shortly after elaborating on this particular point.

[232] See, for example, *Group Five Construction (Pty) Limited v Member of the Executive Council for Public Transport Roads and Works Gauteng* (n 55) par 20-21.

[233] URDG 758 (Art17), ISP98 (rule 3.08).

instrument.[234] According to Bertrams, "[s]uch clauses are common in repayment (advance payment) guarantees securing proper application of the advanced payment from the beneficiary",[235] and thus allow for the guaranteed amount to increase or be reduced. The URDG 758, for example, make provision for such variable guarantees in Article 13 which reads:

> "A guarantee may provide for the *reduction* or the *increase* of its amount on specified dates or on the occurrence of a specified event which *under the terms of the guarantee* results in the variation of its amount […]."[236]

The occurrence of such an event must be demonstrated by documentary evidence[237] to be effective. Documentary evidence would typically include certificates of fitness, payment or performance, delivery notes, or stage completion certificates, which show sufficient progress or certain properties as stipulated for in the guarantee.[238] Once the appropriate (documentary) proof is submitted the variation of the guarantee takes place, thus changing the exposure of the guarantor under the instrument.[239] A demand in excess of the amount available under the guarantee, as determined by the variation clause in the instrument in conjunction with the appropriate documentary proof, can be resisted. The independence principle is not at issue, it must be noted, but the actual terms of the guarantee provide a legal defence against the excessive demand.

A specific issue of potential abuse could arise in regard to a retention money guarantee[240] at an early stage in which not all completion phases have been reached.[241] A clause in the retention money guarantee (akin to the normal variable construction guarantee) could make clear that the potential amount that the beneficiary can claim is limited to the amount of retention money it would in the absence of the guarantee have had at its disposal. If there is

[234] See for example the construction guarantees in *Granbuild (Pty) Ltd v Minister of Transport and Public Works, Western Cape* [2015] ZAWCHC 83 (5 June 2015) par 11; and also in *University of the Western Cape v ABSA Insurance Company Ltd* (n 74) which included a legal mechanism to reduce the maximum amount guaranteed under the instrument (par 1 of the judgment). See further Bertrams (n 28) 40 par 3-6 and 105-106 par 8-18 as well as 310-311 par 13-21; Schütze and Edelmann (n 194) 37 par 9; and Graf von Westphalen and Zöchling-Jud (n 46) 122-124 par 31-35.

[235] Bertrams (n 28) 105 par 8-18.

[236] URDG 758 Art13, emphasis and omission by me.

[237] URDG 758 Art13 (a).

[238] Bertrams (n 28) 105 par 8-18; and Hellner and Steuer *Bankrecht und Bankpraxis* (2006) par 5/277 and 5/278.

[239] Bertrams (n 28) 310 par 13-21.

[240] For retention money guarantees in general see par 4.3.6 above.

[241] For certification in the construction industry see par 5.3.3 above.

such a term *in the guarantee* then, of course, a claim in excess of the available amount would be a breach of contract (the guarantee) and could be resisted by the guarantor accordingly (without having to deal with independence of the guarantee).[242] The refusal to honour the claim on the retention money guarantee would be justified with direct reference to the instrument itself. On the other hand, if such a variation clause is not included in the guarantee, one could deduce that the parties' intention was to permit a full claim under the retention money guarantee regardless of the lack of stage completion,[243] which would give full effect to the independence principle.

In relation to retention money guarantees, Klee furthermore reports on what he terms a clause initiating a *postponed effect*: "As a rule, retention […] guarantees include a clause on their postponed effect from the moment when the retention [money] is actually credited to the contractor's bank account."[244] Such a clause would make any calls on the retention money guarantee conditional upon having released the amount first to the contractor. If there is such a postponement clause *in the guarantee*, then a claim in excess of the available amount would be a breach of contract (breach of the guarantee and its particular terms) and could be resisted without questioning the independence of the guarantee. If such a "postponement clause" is not agreed upon in the guarantee, one may argue, however, that a demand in full under the guarantee may be permissible. The beneficiary and applicant would then have to argue their cases at a later stage after payment has been made under the guarantee,[245] a procedure which is a true reflection of the utilisation of a demand guarantee to ensure certain and swift access to cash, and the principle of independence.

6.6 Conclusion

In conclusion, this chapter presented research relating to instances of potentially abusive demands which may be resisted without necessitating an exception to the principle of independence. Rather, the terms of the guarantee and the principle of documentary

[242] For fraud in the specific context of retention money guarantees see par 5.2.8 above.

[243] See also the deliberations in United Nations Commission on International Trade Law *UNCITRAL Yearbook vol. XXII: 1991* (1992) 345 par 46.

[244] Klee *International Construction Contract Law* (2015) 376 (omission and insertion by me).

[245] See par 3.4.2.4 above.

compliance, *inter alia*, provide the guarantor with valid defences where payment is not justified while leaving the fundamental notion of independence unscathed.[246]

[246] For an investigation into instances of abusive demands and legal responses thereto which may infringe upon the principle of independence, see the in-depth discussions in chapter 5 above.

Chapter Seven: Negative stipulations in the underlying contract

7.1 Introduction

In case law and scholarly writing the thinking has gained ground that the breach of a so-called *negative stipulation* could potentially render a call on a demand guarantee abusive. This issue is investigated in detail in this chapter. In the preceding chapters, defences to a demand for payment were examined which either clearly violated the principle of independence (Chapter Five), or which left the autonomy of guarantees intact but still provided a valid defence to resist an unjustified demand for payment (Chapter Six). The breach of negative stipulations, however, has provoked contradictory legal responses. Because the approaches developed in case law in South Africa, England and Germany potentially deviate regarding their stance on whether to allow violations of the principle of independence or not, the issue of negative stipulations is dealt with in this separate chapter. This serves to highlight the importance of this particular issue, and the almost hybrid nature of this specific form of potentially abusive and impermissible conduct. Attaching it to either one of the preceding chapters, therefore, would have disregarded its particular legal challenges.

Negative stipulations are contractual promises and stipulations in the underlying (construction) contract between the applicant and beneficiary, which may restrict or qualify the beneficiary's entitlement to call up the guarantee.[1] Conceptual problems arise due to the fact that such restricting agreements are *not* contained *in the guarantee* itself, but only *in the underlying (construction) contract* or another *separate contract*. Because demand guarantees are payable strictly in accordance with their terms, without regard to the underlying contract, difficulties may arise. On the one hand, the beneficiary is bound as against the applicant by its promise not to call up the guarantee, or only to call it up in certain circumstances. An example of such a restriction could be a stipulation in the underlying contract in terms of which the beneficiary undertakes to give notice of any intended demands to the applicant in advance, to exhaust certain dispute resolution methods before the guarantee may be called up, or to cancel the underlying construction contract in accordance with certain specified procedures before the beneficiary calls up the guarantee.

[1] Bailey *Construction Law Volume II* (2011) 927-928 par 12.69; Enonchong *The Independence Principle of Letters of Credit and Demand Guarantees* (2011) 209 par 9.02; Horowitz *Letters of Credit and Demand Guarantees* (2010) 143 par 6.17 *et seq*; and Davis *Construction Insolvency* (2014) 811 par 19-041.

On the other hand, the beneficiary holds an unconditional right under the independent demand guarantee against the guarantor, subject only to qualifications and stipulations set forth in the instrument.[2] This brings to the fore conflicting interests and rights, vested in the different parties concerned, which require careful consideration. In this context it is important to have regard to privity of contract, or "Relativität der Schuldverhältnisse" – a matter considered in more detail below. The principle of independence and the need to reconcile legal certainty and commercial predictability with notions of fairness and justice are also relevant. Against this background the issue of negative stipulations and demand guarantees is dealt with below from a South African, English and German perspective.

7.2 South African law

To illustrate a construction scenario within which such an underlying, negative stipulation can be of relevance, regards may be had to *Union Carriage and Wagon Company Ltd v Nedcor Bank Ltd*.[3] In *Union Carriage* the Witwatersrand Local Division heard an appeal on a case involving performance guarantees and letters of credit.[4] The court investigated whether the beneficiary had entered into an agreement with the applicant, stemming from the underlying relationship, not to draw on the letter of credit before a specific event. Due to the fact that the applicant did not rely on such an agreement during the proceedings, the court was not required to decide the matter. However, in an *obiter dictum*, Wunsh J explained:

> "If there was such an agreement, and that is not alleged in this case, and the beneficiary knowing that it had given such an undertaking nevertheless sought to exact payment under the letter of credit, it could conceivably be guilty of fraud. I express no opinion, because it is not necessary to do so."[5]

This judgment can be relied upon to show that South African law is not oblivious of the relevance which the underlying agreement (or another separate agreement) between beneficiary and applicant may have. The conceptual approach proposed by Wunsh J, on the

[2] In German law the situation is even more complicated due to the existence of *Nebenpflichten*. This particular point is dealt with in par 7.4 below.

[3] 1996 CLR 724 (W).

[4] However, the court, as was pointed out in chapter 5 (n 70) above, did not always use the correct terminology when classifying the different instrument. For the discussion at hand, however, one may accept that the particular legal classification does not have an impact.

[5] 735.

other hand, suggests fraud as the basis upon which to deal with breach of a negative stipulation. As pointed out below, this is probably questionable.[6]

In *Kwikspace Modular Buildings v Sabodala Mining Company*,[7] the South African Supreme Court of Appeal had to decide whether to interdict demands under two independent construction guarantees. Kwikspace Modular Buildings Ltd (Kwikspace), a South African construction company, entered into a contract for the building of accommodation units for a gold mining project in Senegal. The employer was Sabodala Mining Company SARL (Sabodala). By way of a choice-of-law clause, the applicable law to the construction project was the law of Western Australia.[8] The construction agreement required Kwikspace to have performance guarantees issued to secure its obligations under the construction contract. Nedbank issued two such guarantees to the beneficiary, Sabodala. They were clearly independent and payable on demand. The two instruments contained, *inter alia*, the promise to guarantee due performance by Kwikspace and the following clauses:

> "[…] and for the payment of all damages or other amount including interest due by the Contractor [Kwikspace] to the Principal [Sabodala] whether in terms of the contract [the underlying construction contract] or consequent upon determination thereof, and also all charges and expenses of whatsoever nature […]
>
> The Bank [Nedbank] undertakes to be bound to effect payment of the above-mentioned amount, or any lesser portion thereof, to the Principal upon receipt by the Bank at the above stated address of the Principal's first written demand that the Contractor has committed a breach of the contract and/or has defaulted thereunder and/or has been provisionally or finally sequestrated or liquidated or placed under judicial management. […]
>
> Notwithstanding anything to the contrary contained herein, the Bank's obligation hereunder shall be construed as principal and not accessory to the obligation of the Contractor and compliance with any demand for payment received by the Bank in terms hereof shall not be delayed, nor shall the Bank's obligations in terms hereof be discharged, by the fact that a dispute may exist between the Contractor and the Principal."[9]

After the relationship between Kwikspace and Sabodala encountered difficulties, Sabodala informed Kwikspace of its intention to call up the guarantees. Kwikspace approached the Johannesburg High Court with an application for an urgent interim interdict, barring Sabodala from presenting the demands for payment to Nedbank. The interdict was granted pending the

[6] This particular point is returned to in par 7.5 below.

[7] 2010 (6) SA 477 (SCA). For convenience, this case is mostly referred to as *Kwikspace* in the course of this thesis.

[8] par 2.

[9] par 4 (per Cloete JA – insertions and omissions by me).

decision of final relief.[10] Final relief was subsequently denied, but leave to appeal to the Supreme Court of Appeal was granted. The SCA, accordingly, was called upon to decide the refusal of the final interdict. Kwikspace advanced several arguments to support its application, the two most important being:

> "that the underlying building contract between the Contractor and the Principal could, as a matter of law, qualify the right of the Principal to present the guarantees for payment to the Bank, despite the unconditional wording of the guarantees; [and secondly] that the building contract did indeed contain such a qualification [mentioning of specific contractual clause]".[11]

Because the underlying construction contract had opted for the application of the law of Western Australia, the SCA first had to investigate the legal position under Australian law regarding the effect of a negative stipulation. With reference to *Wood Hall Ltd v Pipeline Authority*[12] as well as *Clough Engineering Ltd v Oil and Natural Gas Corporation Ltd*,[13] Cloete JA eventually concluded that the particular question of law has been settled in Australia. He quoted liberally from the *Clough Engineering* case:

> "[77] Nevertheless, the authorities have recognised three principal exceptions to the rule that a court will not enjoin the issuer of a performance guarantee, or bond, from performing its unconditional obligation to make payment, The exceptions were succinctly stated, with references to relevant authorities, by Austin J in *Reed Construction Services Pty Ltd v Kheng Seng (Aust) Pty Ltd* (1999) 15 BCL 158 at 164-5 (Reed):
>
> *First* – the court will enjoin the party in whose favour the performance guarantee has been given from acting fraudulently […]
>
> *Second* – the party in whose favour the performance bank guarantee has been given may be enjoined from acting unconscionably in contravention of s 51AA of the TPA [Trade Practices Act 1974] […]
>
> *Third* – the most important exception for present purposes, is that, while the court will not restrain the issuer of a performance guarantee from acting on an unqualified promise to pay (Reed Construction Services at 164 per Austin J):
>
> …if the party in whose favour the bond has been given has made a contract promising not to call upon the bond, breach of that contractual promise may be enjoined on normal principles relating to the enforcement by injunction of negative stipulations in contracts.
>
> It may be preferable not to describe this as an exception but rather as an over-riding rule because it emphasises that the 'primary focus' will always be the proper construction of the contract: *Bateman Project Engineering Pty Ltd v Resolute Ltd* (2000) 23 WAR 493; [2000] WASC 284 *per* Owen J at [30]. Stephen J recognised this in *Wood Hall* at CLR 459; ALR 398-9 by observing that the provisions

[10] par 5.

[11] par 6 (insertions by me).

[12] (1979) 24 ALR 385.

[13] (2008) 249 ALR 458.

> of the contract may qualify the right to call on the undertaking contained in a performance guarantee".[14]

The SCA, after extensive research of Australian law, accepted that it generally allows the enjoinment of a beneficiary who would breach an underlying agreement by submitting a demand under an independent guarantee:

> "It, therefore, seems to me that it can be said with sufficient certainty that Australian law is to the following effect: a building contractor may, without alleging fraud, restrain the person with whom he had covenanted for the performance of the work, from presenting to the issuer a performance guarantee unconditional in its terms and issued pursuant to the building contract, if the Contractor can show that the other party to the building contract would breach a term of the building contract by doing so […]."[15]

It is important to note, at this stage, that Cloete JA (Lewis, Shongwe JJA and Griesel, Theron AJJA concurring) made it clear that he would "expressly refrain from considering whether […] there is any room for a contention that the position in South Africa should be the same as in Australia."[16] However, approaching the question from the normal rules in South African law relating to the enforcement of contract, it has been suggested in legal writing[17] that the position would likely be the same.

Applying Australian law, the court was subsequently faced with the need to analyse the specific clause in the underlying building contract between Kwikspace and Sabodala, and determine whether its wording and construction indeed qualified and restricted the call on the guarantee against Nedbank. With a precursory warning that "the terms of the building contract should not readily be interpreted as conferring such a right",[18] clause 5.5 of the standard-form contract[19] utilised by the construction parties was examined. The provision in the contract read:

> "5.5 Recourse to Retention Moneys and Conversion of Security
>
> A party may have recourse to retention moneys and/or cash security and/or may convert into money security that does not consist of money where –
>
> (a) the party has become entitled to exercise a right under the Contract in respect of the retention moneys and/or security; and

[14] par 7 (omissions and insertions by me).

[15] par 11 (insertion and omission by me).

[16] par 12 (insertion and omission by me).

[17] Hugo "Documentary credits and independent guarantees" 2011 *Annual Banking Law Update* 116 123.

[18] par 11.

[19] Kwikspace and Sabodala had opted for, *inter alia*, the "Australian Standard General Conditions of Contracts AS 2124 – 1992" (par 2).

> (b) the party has given the other party notice in writing for the period stated in the Annexure [which was two days] of the party's intention to have recourse to the retention moneys and/or cash security and/or to convert the security; and
>
> (c) the period stated in Annexure [two days] has or have elapsed since the notice was given."[20]

Kwikspace contended that, on proper reading of this particular clause, an

> "actual enforceable right be vested in the principal before it would be entitled to present the guarantees for payment, and that it was not sufficient for the principal to assert that it *bona fide* believed that it did have such a right; and accordingly, the right could only be enforced, if it were disputed, once the dispute had been finally settled by arbitration or a court."[21]

Although it was not explicitly so stated, clearly Kwikspace relied mainly on clause 5.5 (a), inferring from it the need for Sabodala to be "*entitled* to exercise a right *under the Contract*" as a precondition to exercise its rights *under the guarantee*. The SCA, however, disagreed with this submission. With regard to several Australian cases,[22] the court dismissed this argument. It held, in the first place, that the construction contract did not require of Sabodala to have an "actual right" under the construction contract in order to call up the guarantee. Moreover, in the second place, even if the underlying construction contract did require Sabodala to have such a right, it did in fact have the right.[23] In other words, clause 5.5 of the building agreement did not possess restrictive or qualifying properties so as to interdict the calling up of the demand guarantees, and even if it did, Sabodala was found to have held such an established right.

The particulars of the case allowed the SCA to avoid a clear stance on the question whether negative stipulations in a construction contract could be used under South African law to enjoin a beneficiary from calling up a demand guarantee. Because of the parties' choice of law, the SCA found it unnecessary to express a view on the South African position, and "expressly refrain[ed]"[24] from doing so. Had the parties chosen a different legal system on which no such wealth of scholarship and case law existed, the court may well have been obliged to elaborate on the South African position.[25]

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[20] par 3.

[21] par 13.

[22] See the elaborations in par 13-20 of the judgment.

[23] par 13 and 22. For a detailed discussion of the *Kwikspace* case see Hugo (n 17) 119-123.

[24] par 12 (alteration by me).

[25] See the remarks in par 7 referring to the presumption that foreign is law is the same as the law in South Africa. If the court cannot ascertain the true legal position under the applicable foreign law, therefore, it could be obliged to explain and apply South African law.

In *Eskom Holdings v Hitachi Power Africa*[26] the SCA had another opportunity to deal with negative stipulations. In this case the applicant for several performance guarantees sought to interdict the beneficiary from calling up the guarantees. On behalf of the applicant (Hitachi Power Africa) it was argued, *inter alia*, that the beneficiary (Eskom Holdings) had bound itself during negotiations not to call up the guarantees until a certain date.[27] The SCA, however, found in favour of the beneficiary on the grounds that while indeed an offer was made not to call up the guarantees (in essence an offer for a temporary *pactum de non petendo*), this offer was never accepted by the applicant.[28] Incidentally, it is respectfully suggested that the SCA did not sufficiently identify and distinguish in its judgment the separate legal relationships between beneficiary and applicant on the one hand, and the guarantor and the beneficiary on the other hand. Unfortunately, the court approached the applicant's request for urgent interim relief to a significant extent with reference to the *demand guarantee* and *its terms*. Given the applicant's obvious reliance on the *underlying contract* and the (alleged) pactum de non petendo – emanating only from the relationship between applicant and beneficiary – the terms of the guarantee and the SCA's discussion thereof were rather irrelevant.

Because of the failure to accept the offer for a *pactum de non petendo*, the applicant was in no position to rely upon any concessions proposed. Therefore, again, the SCA was able to decide an appeal concerning negative stipulations in construction contracts without taking a clear stance on the merits.[29]

It is submitted, nevertheless, that the SCA showed appreciation for such negative stipulations in underlying contracts,[30] and that they may be employed to interdict a beneficiary from making a presentation if that would constitute a breach of the construction contract. If South African law would completely reject any relevance of negative stipulations captured in underlying agreements, or *pacta de non petendo* agreed upon by beneficiary and applicant, surely the SCA need not have investigated the question whether the parties had

[26] [2013] ZASCA 101 (12 September 2013).

[27] par 5 *et seq*.

[28] par 21.

[29] This was somewhat disappointing, especially in light of the Supreme Court of Appeal's elaborations on mootness of decisions and the considerable importance of demand guarantees, see par 22 of the judgment.

[30] par 21. Regrettably, the court's discussion in par 13-20, as was remarked earlier, was arguably rather unfortunate and misguided due to the SCA's primary focus on the terms of the guarantee itself.

reached any such agreement (in the construction contract itself or in a *pactum de non petendo*). Thus, one may conclude that the *Eskom Holdings* case provides some support for the contention that negative stipulations in the underlying contract may be enforceable in certain circumstances.

The matter arose in one further recent case in South Africa. In *Sulzer Pumps (South Africa) (Proprietary) Limited v Covec-MC Joint Venture*,[31] the High Court in Pretoria had to rule on a dispute between the beneficiary of a demand guarantee, and the applicant, who filed a motion to have the beneficiary interdicted from calling up the guarantee.[32] The applicant alleged that the beneficiary had promised not to present any demands under the guarantee pending arbitration proceedings. Jansen J agreed with this submission and confirmed the existence of such an agreement between the parties.[33] As to the legal effect such a restrictive agreement would have on the entitlement of the beneficiary to invoke the guarantee, she held:

> "What the old authorities [reference was made, *inter alia*, to Paulus at 113 of the judgment] do demonstrate though, is that not only fraud may prohibit the calling up of a construction guarantee, but also unconscionable conduct and also when a contract to the contrary has been entered into between the relevant parties (in this instance, including the bank)."[34]

Accordingly, she interdicted all calls on the guarantees pending a final arbitral award, which would settle the underlying dispute. Regarding the outcome of the case, the decision is probably correct. It is respectfully submitted, however, that the *Sulzer Pumps* case is "not a well-reasoned"[35] decision. Not only does it lack a clear and orderly line of reasoning, but the legal grounds on which the court finally decided to give effect to the underlying agreement also remain vague.[36] Jansen J further placed emphasis on the fact that the guarantor was involved in the agreement to await the arbitration outcome before the calling up the guarantees.[37] The guarantor's involvement or not, it must be stressed, is entirely irrelevant in the given procedural situation. One should bear in mind that there is a clear conceptual difference between a guarantor being interdicted from honouring a demand under a

[31] [2014] ZAGPPHC 695 (2 September 2014).

[32] For a full case discussion see Kelly-Louw and Marxen "General update on the law of demand guarantees and letters of credit" 2015 *Annual Banking Law Update* 276 287-293; as well as Kelly-Louw "Sulzer Pumps case note" 2015 *Documentary Credit World* (May) 17.

[33] Note her findings in par 108 of the judgment.

[34] par 115 (insertion by me).

[35] Kelly-Louw and Marxen (n 32) 292.

[36] Kelly-Louw and Marxen (n 32) 292-293.

[37] par 115-116.

guarantee, and a beneficiary being interdicted from submitting a demand.[38] In the *Sulzer Pumps* case the application to interdict was brought against the beneficiary, and not the guarantor. Therefore, as Hugo has put it,

> "[a]n interdict against the beneficiary of the guarantee […] which in effect simply enforces the contract between the applicant for the guarantee […] and the aforementioned beneficiary, does not violate the independence of the guarantee […]."[39]

The guarantor did not play any material part in the dispute and resulting court proceedings. Hence Jansen J's emphasis on the bank being involved in the agreement was, at best, superfluous.[40] The merit of the *Sulzer Pumps* case for the South African law on demand guarantees lies in the clear, unequivocal recognition of the principle that calls on a demand guarantee can be prohibited should there be a negative stipulation in the underlying contract which restricts the right of the beneficiary to do so. Furthermore, Jansen J stated that not only fraud is a valid reason in South African law to interdict the calling up of a demand guarantee, but also recognised "unconscionable conduct" and breach of negative stipulations ("a contract to the contrary") as bases for allowing judicial intervention.[41] Although such an unequivocal statement could be appreciated as being supportive of justice and fairness, it is respectfully submitted, however, that the court's findings in this regard were not sufficiently explained or adequately backed up by legal authorities. It is accordingly suggested that this judgment does not provide convincing authority and that a clear decision on this matter by the SCA will be welcomed.

7.3 English law

Negative stipulations and restrictive clauses in the relationship between applicant and beneficiary and their respective legal effects on calls on demand guarantees have also been explored in English law. To illustrate the stance of the English courts regarding judicial

[38] See Cloete JA in *Kwikspace* par 9, where he cites Callaway JA in *Fletcher Construction Australia Ltd v Varnsdorf Pty Ltd* [1998] 3 VR 812; Hugo (n 17) 123; Hugo "Construction guarantees and the Supreme Court of Appeal (2010 – 2013)" in Visser and Pretorius *Essays in Honour of Frans Malan* (2014) 159 170; and Hugo "Protecting the lifeblood of commerce: a critical assessment of recent judgments of the South African supreme court of appeal relating to demand guarantees" 2014 *TSAR* 661 672-673.

[39] (n 17) 123 (alterations and omissions by me). See also Hugo (n 38 *Essays*) 168-170 (although with reference to *Kwikspace Modular Buildings v Sabodala Mining Company*).

[40] Had the applicant tried to interdict the guarantor from honouring and paying out the guarantee, her mentioning of the bank's involvement certainly would have played a crucial role.

[41] par 115.

interventions and interim injunctions in demand guarantee and letters-of-credit transactions in general, the point of departure must be the oft-cited judgment in *RD Harbottle (Mercantile) Ltd v National Westminster Bank Ltd*:[42]

> "It is only in exceptional cases that the courts will interfere with the machinery of irrevocable obligations assumed by banks. They are the life-blood of international commerce. Such obligations are regarded as collateral to the underlying rights and obligations between merchants at either end of the banking chain."[43]

Also, in *TTI Team Telecom International Ltd v Hutchison 3G UK Ltd*,[44] Thornton J warned that "English courts have developed a clear non interventionalist approach".[45] There is accordingly a reluctance to interfere with abstract payment undertakings and the rights which beneficiaries hold under them.[46] In recent years, however, English courts have been called upon to decide cases[47] involving negative stipulations and beneficiaries' promises not to exercise their rights under demand guarantees, some of which require close scrutiny.

The case, decided by the House of Lords in 2004, *Sirius International Insurance Company (Publ) v FAI General Insurance Limited*,[48] related to a complicated insurance scheme. Considerably simplified, the essential facts were that the parties disagreed on a negative stipulation in an underlying (re)insurance transaction which restricted Sirius from drawing on a letter of credit issued to it on behalf of FAI. The Court of Appeal[49] had, in the previous instance, remarked[50] that Sirius, the beneficiary, was restricted from drawing on the letter of credit in terms of the underlying agreement, and, if necessary, could be interdicted from doing so.[51] May LJ held:

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[42] [1977] 2 All ER (QB) 862.

[43] 870a-b (per Kerr J).

[44] [2003] 1 All ER (Comm) 914.

[45] par 31.

[46] Lurie "On-demand performance bonds: is fraud the only ground for restraining unfair calls?" 2008 *The International Construction Lawyer* 443 451 remarked, that "[i]ndeed, there are numerous examples of English and Australian cases where contractors have failed to obtain such relief" (alteration by me). See also Broccoli and Adams "On-demand bonds: a review of Italian and English decisions on fraudulent or abusive calling" 2015 *International Construction Law Review* 103 115-116.

[47] One of these cases was the *TTI Team Telecom* case itself. See further the discussion in Enonchong (n 1) 212 par 9.10-9.11.

[48] [2004] UKHL 54.

[49] *Sirius International Insurance Co (Publ) v FAI General Insurance Ltd* [2003] 1 WLR 2214.

[50] 2225-2226 par 27-30.

[51] Because the money promised under the letter of credit was, per mutual party agreement, put into an escrow account, the situation before the Court of Appeal was different.

> "[H]ad it been necessary to do so, I should have been very strongly inclined to agree with the [court of first instance's] implicit finding that, had the question arisen out of the facts in the present case, the court would have granted an injunction restraining Sirius from drawing on the letter of credit in breach of conditions of the [underlying] agreement […]."[52]

The House of Lords[53] subsequently disagreed, but did so by ruling that the condition contained in the underlying agreement between beneficiary and applicant had been satisfied,[54] rendering the core issue regarding the legal effect of a negative stipulation on an abstract payment obligation moot.[55] The notion that a beneficiary could be injuncted from calling up a guarantee on the basis of an underlying negative stipulation was *not*, however, rejected.[56] It was simply not necessary to answer this question. Enonchong,[57] commenting on the *Sirius* case accordingly concluded that the question remained, until then, unsettled in English law.

The general legal principle developed in the Sirius case was referred to with approval in *Permasteelisa Japan KK v Bouyguesstroi and Banca Intesa SpA*, where Ramsey J held:

> "In my judgment […] a court might grant an injunction where there is an express term restricting the circumstances in which a party can draw on a letter of credit and where it is positively established that the party was not entitled to draw down […]."[58]

The injunction was eventually denied in this case based on, *inter alia*, the balance of convenience test.

The issue of negative stipulations came to the fore subsequently again in the landmark case[59] of *Simon Carves Limited v Ensus UK Limited*.[60] In this case before the High Court of Justice, Queen's Bench Division (Technology and Construction Court), the parties to a

[52] 2225 par 29 (Carnwath LJ concurring, and Wall J in agreement with qualifications – alteration, insertions and omissions by me).

[53] n 48.

[54] par 25.

[55] par 26.

[56] On this point note also the observation in Lurie (n 46) 461: "[t]he *Sirius International* decision does, however, highlight the increasing willingness of English courts to now look beyond the documents presented and to acknowledge the possibility of a negative stipulation exception" (alteration by me).

[57] (n 1) 213 par 9.12.

[58] [2007] EWHC 3508 par 51 (omissions by me).

[59] Adams "New clots in the life-blood of international construction projects: enjoining employers' calls on performance bonds" 2014 *Construction Law Journal* 325 328 writes of "[t]he courts' approach to 'on-demand' bonds pre-Simon Carves" (alteration by me), emphasising the judicial weight of this decision. See further Broccoli and Adams (n 46) 118 who state that the case "marked a sea-change in the court's approach to performance bonds".

[60] *Simon Carves Limited v Ensus UK Limited* [2011] EWHC 657 (TCC).

construction project for a bioethanol plant were in dispute as to the validity of a demand guarantee and possible calls thereunder.[61] The court had to decide whether to extend an injunction enjoining the beneficiary (Ensus) from calling up a demand guarantee (or withdraw such a demand respectively) to make good for defective workmanship.[62] The applicant (Simon Carves) submitted that due to a clause in the underlying construction agreement and certain events the guarantee had become "null and void" and ought to be "returned to the Contractor".[63] The court, after examination of various English authorities,[64] concluded that

> "[t]here has been little jurisprudence on the circumstances which arise in which there are contractual provisions between contractor and purchaser/employer which impose restrictions or which prevent calls being made on bonds or letters of credit."[65]

Akenhead J went on to quote at length from the Court of Appeal's judgment in the *Sirius* case and eventually summarised the English law as follows:

> "In my judgement one can draw from the authorities the following:
>
> (a) Unless material fraud is established at a final trial or there is clear evidence of fraud at the without notice or interim injunction stage, the Court will not act to prevent a bank from paying out on an on demand bond provided that the conditions of the bond itself have been complied with (such as formal notice in writing). However, fraud is not the only ground upon which a call on the bond can be restrained by injunction.
>
> (b) The same applies in relation to a beneficiary seeking payment under the bond
>
> (c) There is no legal authority which permits the beneficiary to make a call on the bond when it is expressly disentitled from doing so.
>
> (d) In principle, if the underlying contract, in relation to which the bond has been provided by way of security, clearly and expressly prevents the beneficiary party to the contract from making a demand under the bond, it can be restrained by the Court from making a demand under the bond.
>
> (e) The Court when considering the case at a final trial will be able to determine finally what the underlying contract provides by way of restriction on the beneficiary party in calling on the bond. […]."[66]

[61] For a detailed case discussion see Kelly-Louw and Hugo "Documentary credits and independent guarantees" 2012 *Annual Banking Law Update* 73 89-95.

[62] par 23-24.

[63] par 5.

[64] *Sirius International Insurance Co (Publ) v FAI General Insurance Ltd* (n 49); *Edward Owen Engineering Ltd v Barclays Bank International Ltd* [1978] QB 159; and *RD Harbottle (Mercantile) Ltd v National Westminster Bank Ltd* (n 42).

[65] par 29 (alteration by me).

[66] par 33 (omission and insertion by me).

This is a clear exposition on the legal effect of negative stipulations in underlying transactions on the validity of calls under demand guarantees. Applying these principles the court extended the injunction preventing Ensus from submitting calls under the guarantee. It is submitted, that never before had an English court spelt out the law so clearly.

In *Doosan Babcock Ltd v Comercializadora de Equipos y Materiales Mabe Lda (formerly Mabe Chile Lda)*,[67] parties to a power plant construction project were in dispute over the installation of two boilers. An injunction to prevent calls on a guarantee issued in favour of the employer was subsequently granted.[68] The court fully endorsed the reasoning of Akenhead J in the *Simon Carves* case.[69] Edwards-Stuart J put it thus:

> "I accept that this decision [*Simon Carves Limited v Ensus UK Limited*] has extended the law, but in my view it has done so adopting a principled and incremental approach that does not undermine the general principles applicable to interim injunctions to restrain a party making a call on a bond. I adhere to my original view that this decision justifies the grant of interim relief in this case if the Claimant can show a strong case."[70]

Barring a future decision by a higher court it would be proper to state that the English law regarding negative stipulations in underlying contracts is now well-settled. In light of this, Choat and Steensma[71] argue:

> "This principle might well be applied where, for example, the underlying contract contains a term like sub-clause 4.2 in each of the FIDIC Red, Yellow and Silver Books of 1999, the Pink Books of 2005, 2006 and 2010 and the Gold Book of 2008. That clause states in each form (sometimes followed by express exceptions, which only further constrain the employer's right to call) that: 'The Employer shall not make a claim under the Performance Security, except for amounts to which the Employer is entitled under the Contract.' There now seems to be more scope for the Contractor under many FIDIC forms to challenge the employer's call upon an English law on-demand bond, where the employer claims more than his entitlement is (or could conceivably be) under the underlying contract."

It should be noted, however, as emphasised by Enonchong,[72] that interventions on the basis of negative stipulations are available only to the applicant and not the guarantor. This is due to the fact that English law, similar to the position in South African law, regards the issue of negative stipulations in the context of demand guarantees *not* to be a true exception to the

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[67] [2013] EWHC 3201 (TCC).

[68] For a concise summary of the judgment see Lawrence "On demand guarantees Doosan Babcock Limited v Comercializadora de Equipos y Materiales Mabe Limitada" 2013 *Butterworths Journal of International Banking and Financial Law* 650. For a case discussion, see Adams (n 59) 331 *et seq*; and Broccoli and Adams (n 46) 120-122.

[69] par 32-36. For a case summary and analysis see Byrne, Byrnes, Brown and Traisak *2014 Annual Review of International Banking Law and Practice* 437-439.

[70] par 36 (explanatory insertion by me).

[71] "On-demand bonds: recent English law developments" 2013 *Construction Law International* 13 19.

[72] (n 1) 217 par 9.21.

principle of independence, but rather as a question of *enforcement of the underlying contract* or separate agreement. Moreover, as was made plain in the *Simon Carves* case, it is crucial to bear in mind that the negative stipulations or restrictions in the underlying contract must be *expressed clearly* – implied restrictions and obligations are unlikely to suffice under English law.

7.4 German law: the concept of "Nebenpflicht", negative stipulations and independent construction guarantees

In German law negative stipulations and other legal restrictions originating from the underlying construction contract can also have a bearing on the validity of demands on independent construction guarantees.[73] Should the underlying contract contain provisions (express or implied) which restrict or qualify the beneficiary's right to convert the demand guarantee into cash, German courts can be approached and, provided the call in breach of the underlying contract amounts to a *Rechtsmissbrauch* (abuse of rights), interdict the beneficiary on the applicant's motion.

The *Bundesgerichtshof* has allowed urgent interdicts against beneficiaries in circumstances where it was *evident and absolutely incontestable* that the underlying contract did not and would not give rise to material entitlement.[74] Although the court occasionally made reference to both the law of unjustified enrichment and contractual obligations as the cause of action – which implies two different, dogmatically distinct ways of legal justification – interim relief ("einstweilige Verfügung") is clearly available in German law.[75] It must be borne in mind, however, that the lack of material entitlement, and thus the abusive conduct by the beneficiary, must be *clear and evident* without the need for additional investigation or

[73] Schütze and Edelmann *Bankgarantien* (2011) 152 ("[d]ie Rechtsmissbräuchlichkeit der Inanspruchnahme einer Garantie kann sich liquide auch unmittelbar aus den Vertragsbedingungen des Valutaverhältnisses ergeben" – alteration by me).

[74] BGH 1984 *WM* 1245 1247; and BGH 1987 *WM* 367 369. See also BGH 2002 *WM* 743 744 (although evaluating a contract of suretyship, payable on first demand, and eventually denying a case of *Rechtsmissbrauch* due to lack of admissible evidence, the case adds value to the understanding of German law also in regard to demand guarantees).

[75] BGH (n 74 *1984*) 1247 was for instance largely based on considerations derived from the law of unjustified enrichment. BGH (n 74 *1987*) 369, on the other hand, mentioned in addition contractual obligations as the cause of action.

clarification.[76] The point of departure is the notion that, under German law, an applicant has got a right *against the beneficiary* to have it realise a demand guarantee only and insofar as it is materially entitled to in accordance with the *underlying contract*.[77] The underlying contract, for instance a construction contract, does not even have to stipulate expressly for such qualifications or restrictions.

Generally, German law recognises main obligations ("Hauptpflichten") arising from a contract, and so-called "Nebenpflichten", that are ancillary, complementary or collateral duties or obligations which serve to protect and supplement the main obligation, especially so-called "Schutz- und Treuepflichten".[78] The main obligations are usually clearly set out in any contract, with details as to quality and quantity of services to be rendered or goods to be delivered, payment and security obligations and so on. "Nebenpflichten", on the other hand, do not necessitate express incorporation into the contract. They do not need to be mentioned at all. With regard to paragraphs 241 (2) and 242 of the *BGB*, courts will not hesitate to give effect to any contract by inferring, interpreting, identifying or imposing far-reaching ancillary obligations onto parties. Mostly such ancillary obligations force the party to refrain from engaging in activities which would have detrimental effects on the contract, its execution, the

[76] BGH 2011 *WM* 2216; BGH *BGHZ* 145, 286 291; BGH *BGHZ* 90, 287 292; OLG Bremen 1990 *WM* 1369; and Edelmann "Blockierung der Inanspruchnahme einer direkten Auslandsgarantie" 1998 *Der Betrieb* (*DB)* 2453.

[77] BGH (n 74 *1984*) 1247; BGH (n 74 *1987*) 369; BGH 1996 *NJW* 1812 1813 (letter of credit); BGH (n 74 *2002*) 743 (suretyship contract payable on first demand, "Bürgschaft auf erstes Anfordern"); OLG Saarbrücken 2001 *WM* 2055 2061; Pleyer "Die Bankgarantie im zwischenstaatlichen Handel" 1973 *WM* (Sonderbeilage 2/1973) 24 and 26; Mülbert "Neueste Entwicklungen des materiellen Rechts der Garantie 'auf erstes Anfordern'" 1985 *Zeitschrift für Wirtschaftsrecht* (*ZIP)* 1101 1111 par 2; Horn "Bürgschaften und Garantien zur Zahlung auf erstes Anfordern" 1980 *NJW* 2153 2157 par V.1; Schütze "Die Sicherung von Ansprüchen aus mißbräuchlicher Inanspruchnahme von Bankgarantien auf erstes Anfordern durch Arrest" 1981 *Der Betrieb* (*DB)* 779 (par 1); Edelmann (n 76) 2453 (without substantiating, however, the proper legal basis of the applicant's right); Mahler *Rechtsmißbrauch und einstweilliger Rechtschutz bei Dokumentenakkreditiven und 'Akkreditiven auf erstes Anfordern'* (1986) 95 (Mahler's remarks were made with specific reference to letters of credit but are equally applicable to demand guarantees); and Canaris *Bankvertragsrecht Erster Teil* (1988/2005) 788 par 1152. See also the considerations in OLG Cologne 1988 *WM* 21 22: "Er setzt damit in seinen Vertragspartner das Vertrauen, daß dieser die Garantie nur dann in Anspruch nehmen wird, wenn er nach sorgfältiger Prüfung der Überzeugung ist, der materielle Garantiefall sei eingetreten." (The applicant relies on its counterpart to call up the guarantee only after careful considerations regarding its actual material entitlement – translation is my own).

[78] Ancillary contractual duties relating to protection, consideration and fiduciary obligations. See Larenz *Lehrbuch des Schuldrechts Erster Band Allgemeiner Teil* (1987) 6-15; Schlechtriem and Schmidt-Kessel *Schuldrecht Allgemeiner Teil* (2005) 89-91 par 162-165; Köhler "Vertragliche Unterlassungspflichten" 1990 (190) *Archiv für die civilistische Praxis* (*AcP)* 496 498 and 503 *et seq*; Wiesen *Zivilprozeßrechtliche Probleme der Unterlassungsklage* (2005) 92-93 par b; and Esser and Schmidt *Schuldrecht Band I Allgemeiner Teil Teilband 1* (1995) 105-110.

main obligation or the contractual party itself.[79] Such contractually prohibited activities can range from being negligent when delivering the promised goods or services under the contract, causing harm to the other party or its rights, interests or possessions, or showing insufficient regard and consideration for the other party.

The German notion of "Nebenpflichten" is clearly very flexible, which allows the judiciary to intervene in and shape contractual relationships to ensure proper performance without disregarding the wider circumstances and reasonable expectations of the parties. With this in mind, it has been argued that a beneficiary who intends to call up a demand guarantee – without being materially entitled to do so with regard to the underlying contract – would be in breach of such a "Nebenpflicht" (in this case an implied, or sometimes express, obligation not to make use of the security unless materially entitled to do so). If the breach is obvious and clear, and thus would constitute an abuse of rights (*Rechtsmissbrauch*), it can be interdicted.[80] It is important to note that the doctrine of *Rechtsmissbrauch*, aimed at prohibiting abusive behaviour by beneficiaries owed to the abstract nature of demand guarantees in general, constitutes the crucial legal component to engage negative stipulations and restrictions originating from the underlying contract.

7.5 Analysis and comparative remarks regarding negative stipulations

South African, English and German law have each dealt with negative stipulations and agreements in the underlying contract not to call up guarantees and letters of credit under their domestic laws. It is probably correct to assume that all three legal systems acknowledge

[79] Weiler *Schuldrecht Allgemeiner Teil* (2016) 76-77 par 10-13; Wiesen (n 78) 92-93 par b; Brox and Walker *Allgemeines Schuldrecht* (2015) 78 par 1 and 80-82 par 7-10; Medicus and Lorenz *Schuldrecht I Allgemeiner Teil* (2015) 50-51 par 113-114; and Looschelders *Schuldrecht Allgemeiner Teil* (2015) 6-8 par 19-21.

[80] See the instructive discussions in Mülbert *Mißbrauch von Bankgarantien und einstweiliger Rechtsschutz* (1985) 149 *et seq*; Pleyer (n 77) 24 and 26; Canaris (n 77) 788 par 1152; Mülbert (n 77) 1111 par 2; Horn (n 77) 2157 par V.1; Schütze (n 77) 779 (par 1); Nielsen "Rechtsmißbrauch bei der Inanspruchnahme von Bankgarantien als typisches Problem der Liquiditätsfunktion abstrakter Zahlungsversprechen" 1982 *Zeitschrift für Wirtschaftsrecht und Insolvenzpraxis (ZIP)* 253 260 *et seq*; Blesch and Lange *Bankgeschäfte mit Auslandsbezug* (2007) 177-178 par 583; Ehrlich and Haas *Zahlung und Zahlungssicherung im Außenhandel* (2010) 481-482 par 9/142-9/143; and Schütze and Edelmann (n 73) 152. See further Wessely *Die Unabhängigkeit der Akkreditivverpflichtung von Deckungsbeziehung und Kaufvertrag* (1974) 74-75 (par 190-192) as well as 79-80 (par 206-208); and Mahler (n 77) 95 (although both authors, Wessely and Mahler, wrote with specific reference to letters of credit, their remarks should be equally applicable to demand guarantees). For the position under Austrian law, see Mader *Rechtsmißbrauch und unzulässige Rechtsausübung* (1994) 209-210. Further, see the stricter approach favoured by Apathy, Iro and Koziol *Österreichisches Bankvertragsrecht Band V: Akkreditiv und Garantie* (2009) 259-260 par 3/55 (their discussion relates to German and Austrian law).

– with different degrees of clarity and certainty – to give effect to such agreements or restrictions. While the South African courts have expressed a cautious openness in this regard, the German law acknowledges more clearly that stipulations or restrictions emanating from the underlying relationship can defeat a claim on a demand guarantee. The pivotal point is the ability to subsume the conduct of the beneficiary under the concept of *Rechtsmissbrauch*, necessitating a clear and obvious lack of material entitlement on the part of the beneficiary.

The English law, in the House of Lord's decision in *Sirius International Insurance Company (Publ) v FAI General Insurance Limited*, expressed no clear opinion on the matter, but in *Simon Carves Limited v Ensus UK Limited* the High Court of Justice Queen's Bench Division (Technology and Construction Court), unequivocally affirmed that negative stipulations in the underlying contract can be used to enjoin a beneficiary from calling up the guarantee. Subsequently, the reasoning by Akenhead J was applied with approval in *Doosan Babcock Ltd v Comercializadora de Equipos y Materiales Mabe Lda (formerly Mabe Chile Lda)*.

Where the three legal systems remain conceptually vague or even deviate, however, is the question of the appropriate legal approach: in South Africa's *Union Carriage and Wagon Company Ltd v Nedcor Bank Ltd*, Wunsh J indicated that the *fraud exception* could be applicable in such a scenario. Accordingly, a beneficiary could be perceived as acting fraudulently should it choose to claim under a demand guarantee notwithstanding the restrictive provisions in the underlying contract. In *Sulzer Pumps v Covec-MC Joint Venture*, on the other hand, the courts seem to have rather identified the rule which gives effect to a negative stipulation as belonging to a *separate, individual category*. This, however, was done without proper, conceptually-sound explanation. Lastly, the South African Supreme Court of Appeal left classification questions largely unanswered in *Eskom Holdings v Hitachi Power Africa* and in the earlier case of *Kwikspace*.

In Germany, an express agreement and even implied restrictions originating from the underlying contract can potentially give rise to a right vested in the applicant, which enables it to bar documentary presentations and demands on the instruments. The conflicting notions (legal certainty and material justice) are approached through the prism of the doctrine of *Rechtsmissbrauch*. It is predicted that most cases involving express negative stipulations

would result in similar legal outcomes, despite the different domestic mechanisms recognised in South African, English and German law.

English law, as far as one can tell at the moment, has not revealed an explanation regarding its conceptual approach. From Akenhead J's deliberations in *Simon Carves Limited v Ensus UK Limited*, it can be deduced that English law tends to categorising the negative stipulation rule as an issue which is separate and distinct from the established fraud exception.[81] With his finding that "fraud is not the only ground upon which a call on the bond can be restrained by injunction" and the almost immediately following remarks on negative stipulations, being that

> "In principle, if the underlying contract, in relation to which the bond has been provided by way of security, clearly and expressly prevents the beneficiary party to the contract from making a demand under the bond, it can be restrained by the Court from making a demand under the bond",

logically he put it on a *different conceptual footing*.[82] Furthermore, with this particular decision, English law put emphasis on the negative stipulation and the requirement of such clauses or agreement to have the intention of "clearly and expressly"[83] restricting the beneficiary. This stands in contrast to the solution offered in German law. With its doctrine of *Rechtsmissbrauch*, obviousness and clearness are also essential – however not necessarily in regard to the *negative stipulation* itself, but in relation to the *lack of material entitlement* on the part of the beneficiary. If the lack of entitlement is obvious, manifest and clear, the demand for payment can be opposed.

Yet another interesting point could set apart the position under German law from the internationally accepted procedures. Generally, it is argued that negative stipulations and breaches of the underlying contract may only be raised – if at all – by the applicant against the beneficiary; negative stipulations do not, and should not, concern the guarantor.[84] The guarantor, not privy to the underlying agreement cannot be involved, but would have to be

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[81] n 60 (especially par 33-34).

[82] Per Akenhead J, *Simon Carves Limited v Ensus UK Limited* (n 60) par 33. Moreover, Akenhead J confirmed this submission as he continued in par 34 in the following: "It is possible to get into an academic debate as to whether the proposition which I raise at Paragraph 33 (d) reflects a type of fraud in that the beneficiary is seeking to call on the bond when it knows or can be taken to know that the underlying contract forbids it from doing so or whether the proposition reflects another exception to the practice that the Courts will only rarely intervene to restrain calls being made or honoured. It is unnecessary to decide this but in my view it represents a second type of exception".

[83] *Simon Carves Limited v Ensus UK Limited* (n 60) par 33 (d).

[84] *Basil Read (Pty) Ltd v Nedbank Ltd* [2012] ZAGPJHC 101 (especially par 29); and Enonchong (n 1) 217 par 9.21.

allowed and *obligated* to honour is independent promise under the guarantee without judicial intervention.[85] Thus, each case must be decided with clear appreciation as to the party which is sought to be interdicted or prohibited from executing the demand-guarantee transaction. If *guarantors* were to be interdicted due to a negative stipulation originating from the underlying relationship, the independence principle would be infringed upon, making the need to prove fraud by the beneficiary necessary, at least in South African and English law. On the other hand, if the judicial intervention is aimed at stopping the *beneficiary* from commencing or continuing to demand payment under the guarantee, then the independence principle is not violated.[86] Although the practical outcome would be effectively the same, that is the demand guarantee would not be converted and paid,[87] it makes a decisive difference from a conceptual point of view. The intervention against the beneficiary alone would not concern the guarantor and its abstract, independent promise under the guarantee, but it would simply enforce the agreement between the immediate parties to the construction contract and their respective promises to restrict the circumstances in which the security instrument may be relied on.[88] Enonchong explained:

> "The exception is only available to the account party or other third party with whom the beneficiary has an agreement restricting the beneficiary's right to demand payment under the instrument. It cannot be relied on by the issuer (the bank), who is not a party to the relevant underlying transaction or other agreement. The doctrine of privity precludes the bank from relying on the fact that a demand, which complies with the requirements of the instrument, has been made in breach of an agreement to which the bank is not a party."[89]

Incidentally, Enonchong – like other authors[90] – uses the term "exception" to describe the impact a negative stipulation can have on a call under a demand guarantee, and suggests interference with the principle of autonomy. This is unfortunate, since giving effect to the negative stipulation by way of injunctions *against the beneficiary* would not infringe upon the independence principle, as argued above, but rather enforce the original, underlying

[85] Enonchong (n 1) 215 par 9.18.

[86] Horowitz (n 1) 28-29 par 2.19 (with reference to *Themehelp Ltd v West* [1996] QB 84 (CA)); Hugo and Marxen "Documentary credits and independent guarantees" 2013 *Annual Banking Law Update* 25 28; and Hugo "Bank guarantees" in Sharrock *The Law of Banking and Payment in South Africa* (2016) 437 447. Seemingly of a different view, however, is Bertrams *Bank Guarantees in International Trade* (2013) 434.

[87] See Bridge *Benjamin's Sale of Goods* (2014) 2218 par 24-033.

[88] Hugo (n 38 *Essays*) 170, and Hugo (n 38 *TSAR*) 672 and 674.

[89] (n 1) 217 par 9.21.

[90] Bertrams (n 86) 434; Lurie (n 46) 461 and 464; similar also Wood *International Loans, Bonds, Guarantees, Legal Opinions* (2007) 373-374 par 20-021 ("All of these [*inter alia* interim injunctions against the beneficiary] in effect interfere with the autonomy of the guarantee" – insertion by me).

contract. Therefore, it is suggested, the expression "exception" does not accurately capture the legal mechanisms involved. What is evident from Enonchong's statement, however, is the fact that the breach of a negative stipulation cannot be used for judicial intervention *against* the guarantor, but also the guarantor itself *cannot* invoke it as a defence on its *own volition* to resist a demand for payment. This is the position in English and South African law. As was remarked earlier, German law could differ in this particular regard when examined with a strong focus on the domestic concept of *Rechtsmissbrauch*. Under German law, also the guarantor may be in a position to resist a demand for payment if the breach of the underlying agreement amounts to an abuse of rights.[91] Even further, one could argue that the guarantor is not only *able*, but even always *obliged* (as against the applicant) to raise the defence of *Rechtsmissbrauch* and resist claims under the guarantee.[92] Importantly, it should be noted that the question whether the guarantor is able, or even under an obligation, to plead the *Rechtsmissbrauch* defence once the beneficiary claims in an abusive manner, is not restricted to cases involving negative stipulations, but surfaces in all possible constellations of potential *Rechtsmissbrauch*.

Consequently, and assuming for argument's sake, that under German law the guarantor is contractually bound to advance the defence of the abuse of rights, then the guarantor could even be interdicted by the applicant should it show reluctance to raise the defence of *Rechtsmissbrauch*. Again, this is a result of the different concepts with which abusive conduct in demand-guarantee transactions is approach: *fraud* being the central concept in most jurisdictions, including South Africa and English common law, while Germany operates with the *Rechtsmissbrauch* doctrine, which is capable of covering conduct contrary to negative stipulations and restrictions arising from the underlying contract in a different manner. German courts and some commentators,[93] however, disagree with such an

[91] Schütze and Edelmann (n 73) 99 par 5 and 118; and Heinze *Der einstweilige Rechtschutz im Zahlungsverkehr der Banken* (1984) 150-151.

[92] See for instance OLG Celle 2009 *WM* 1408 1410; and Heinze (n 91) 152. The court in OLG Bremen (n 76) left the question unanswered due to the particular procedural situation.

[93] OLG Stuttgart 2012 *Zeitschrift für Wirtschaftsrecht und Insolvenzpraxis* (*ZIP)* 2388; OLG Cologne 1991 *WM* 1751 1752; OLG Frankfurt 1988 *WM* 1480 1482; OLG Stuttgart 1981 *WM* 631 632; and OLG Frankfurt 1981 *NJW* 1914. The recent decision in OLG Munich 7 U 1934/12 (27.05.2015) (juris), admittedly, showed some openness and did not rule out the possibility, in principle, for the guarantor to be interdicted. Ehrlich and Haas (n 80) 480 par 9/140 write: "Etwaige Eingriffe seitens des Garantieauftraggebers in die abstrakte Zahlungsverpflichtung stehen im Widerspruch zu der von den Parteien ausgehandelten und akzeptierten Risikoverteilung, beeinträchtigen die Liquiditätsfunktion der Bankgarantie und sind deshalb grundsätzlich nicht zulässig" (interference by the applicant with the abstract payment obligation violates the accepted distribution and assumption of risks, has detrimental effect on the liquidity of the guarantee and is therefore

assessment and stress the idea of privity of contract and "Relativität der Schuldverhältnisse", and the inherent notions of an independent, abstract guarantee transaction *per se*; the guarantor itself must be allowed to gauge and determine whether the conduct of the beneficiary really constitutes an abuse of rights. German courts, most probably, would therefore refrain from issuing interdicts which would restrain the guarantor to pay out the promised amount under the independent guarantee due to allegations by the applicant of abusive conduct.[94] The mere fact that the applicant is of the opinion that towards it, with reference to the underlying contract, the beneficiary is overstepping its material entitlement by invoking formal rights under the guarantee, cannot mean that the guarantor must agree with this assessment. Rather, the guarantor ought to be granted its own discretion whether to honour a guarantee or not, without being interdicted.[95] Because of concerns regarding international standing and credibility, banks acting as guarantors may even be inclined to accommodate calls on a demand guarantee despite doubts as to its material validity.[96] Should it materialise, in hindsight, that indeed the beneficiary acted *rechtsmissbräuchlich* (abusively)

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prohibited – my translation). For a thorough, very detailed and valuable analysis of the issue see Mülbert (n 80 *Mißbrauch*) especially 92 *et seq*. Additionally, regard may be had to Zöller *Zivilprozessordnung Kommentar* (2016) paragraph 940 2221 par Bankrecht; Schütze and Edelmann (n 73) 146-147 par 1.1; Jedzig "Aktuelle Rechtsfragen der Bankgarantie auf erstes Anfordern" 1988 *WM* 1469 1471; Mahler (n 77) 93-109; Coing "Probleme der internationalen Bankgarantie" 1983 *Zeitschrift für das gesamte Handelsrecht und Wirtschaftsrecht (ZHR)* 125 137-138; Nielsen (n 80) 262 *et seq*; and Liesecke "Die neuere Rechtsprechung, insbesondere des Bundesgerichtshofes, zum Dokumentenakkreditiv" 1966 *WM* 458 468 par XII. Further, see also Fritzsche *Unterlassungsanspruch und Unterlassungsklage* (2000) 88 *et seq*. For a view to the contrary, Graf von Westphalen and Zöchling-Jud *Die Bankgarantie im internationalen Handelsverkehr* (2014) 305 *et seq*; Heinze (n 91) 156-161; Horn (n 77) 2158 par 2; Horn and Wymeersch *Bank-Guarantees, Standby Letters of Credit and Performance Bonds in International Trade* (1990) 55 (it is respectfully submitted, however, that Horn and Wymeersch, writing in 1990, did not support their claims ("prevailing legal opinion") with sufficient sources and authorities); and the following commentators (albeit more cautiously): Blesch and Lange (n 80) 178-180 par 584-587; Canaris (n 77) 779-780 par 1140; and Pleyer (n 77) 25 par 2.

[94] In this regard, note the very interesting case of OLG Düsseldorf 6 U 268/11 (04.10.2012) (juris) dealing with legal impossibility (or lack thereof) should such an interim injunction ("einstweilige Verfügung") be granted against the guarantor, especially par 44-50.

[95] OLG Cologne (n 93) 1752 (arguing that a guarantor be allowed to decide independently whether to honour a call on a guarantee or not – "Ob die Bank die eingegangene – eigene – Verpflichtung gegenüber dem Begünstigten erfüllt, ist allein ihre Sache"); OLG Frankfurt (n 93 *1988*) 1482; and OLG Stuttgart (n 93 *1981*) 632. See also Lehtinen "Demand guarantees in construction contracts: the Finnish perspective" 2010 *The International Construction Law Review* 511 520 and 522.

[96] OLG Frankfurt (n 93 *1988*) 1482 ("In diesem Zusammenhang darf nicht übersehen werden, daß ein Bankinstitut, das auf die Gewährung solcher Garantie im internationalen Verkehr spezialisiert ist, geneigt sein kann, aus allgemeinen geschäftlichen Rücksichten eine Garantieverpflichtung selbst dann zu erfüllen, wenn ein Rechtsmißbrauch möglich erscheint" – insertion and omission of reference by me). See also Schütze and Edelmann (n 73) 118-119 par 2 and 121 par 3.2; Jedzig (n 93) 1471; Edelmann (n 76) 2454 par 5; and Mahler (n 77) 101. For a different explanation, see Dunham "The use and abuse of first demand guarantees in international construction projects" 2008 *The International Construction Law Review* 273 279.

and the guarantor ought to have noticed the abuse, then the guarantor's right to be reimbursed by the applicant would fall away.[97] Accordingly, in the German courts, the applicant's rights are not at stake at this early stage of the guarantee transaction, so that an interim interdict against the guarantor is not permissible.[98] The *Oberlandesgericht Saarbrücken* and lower courts of first instance,[99] on the other hand, declared interim injunctions ("einstweilige Verfügung") to be permissible *against a guarantor*. With regards to the wealth of more authoritative court decisions to the contrary, *Oberlandesgericht Saarbrücken*, with respect, cannot be considered an accurate reflection of the German law anymore. In conclusion, German courts are unlikely to agree to an application for an urgent interdict which restricts the *guarantor* from honouring a demand guarantee.[100]

The analysis of case law and scholarship has shown that English, South African and German law have dealt with the breach of negative stipulations and its impact on demand guarantees. The position under English law is, in light of *Simon Carves Limited v Ensus UK Limited*, reasonably settled. It supports the notion that such a breach may give rise to an interdict against the beneficiary. Less certain then is, however, the South African law in this regard. Although the courts have had opportunities to rule on this particular issue, they have not done so with sufficient clarity – for various reasons. As a result, it would not be prudent to present the South African law as firmly established and predictable; although indications provided in judgments have suggested judicial favour to assume a position in the future which is comparable to English law. German law will give effect to underlying stipulations and restrictions, and allow for an interdict *against the beneficiary* – provided the beneficiary evidently lacks material entitlement due to the restriction, and thus committed a *Rechtsmissbrauch*. An interdict *against the guarantor*, barring it from accommodating a

[97] OLG Cologne (n 93) 1752; and OLG Frankfurt (n 93 *1988*) 1482. See also LG Dortmund 1988 *WM* 1695 in this regard; Schütze and Edelmann (n 73) 99 par 5 and 118 as well as 121 par 3.2; and Canaris (n 77) 753 par 1111.

[98] OLG Stuttgart (n 93 *2012*) 2388; OLG Stuttgart (n 93 *1981*) 632; and OLG Frankfurt (n 93 *1981*) 1914. For criticism towards such a view, see Hugo and Marxen (n 86) 35; Edelmann (n 76) 2456 par 4; and also Horn and Wymeersch (n 93) 55-56.

[99] OLG Saarbrücken 1981 *WM* 275 277; LG Frankfurt 1981 *WM* 284 286; LG Dortmund 1981 *WM* 280 282; and more recently LG Cologne 91 O 8/11 (18.02.2011) (juris) par 28 (although involving a letter of credit and not a demand-guarantee transaction). Further examples of judgments of lower courts are listed in Ehrlich and Haas (n 80) 483 par 9/145 (n 386).

[100] In addition, even if an injunction is obtained, the judgment in OLG Düsseldorf (n 94) must be considered carefully.

demand which is in violation of an underlying negative stipulation, was held possible only by some German courts.

7.6 Conclusion

This chapter concludes the centre piece of the thesis with elaborations on the breach of negative stipulations in underlying contracts as a specific form of potentially abusive conduct. The results of the comparative legal analysis, however, showed a possible deviation in the way in which the jurisdictions under examination may deal with the issue: while evidence can be found in (some) German cases that the breach of negative stipulations could give rise to the involvement of the guarantor and an exception to the principle of independence, most authorities point towards a different approach which preserves the independence of the guarantee and restricts the dispute to the parties privy to the underlying contract. This conceptual difference, however, warranted dealing with this issue in a separate chapter due to the fact that it does not fit comfortably into either of the previous chapters which are divided along this particular line (offering defences which either *violate* the principle of independence, Chapter Five; or which *preserve* the principle of independence, Chapter Six). This is a potentially hybrid form of abusive conduct.

In conclusion, Chapters Five to Seven, which contain the heart of this thesis, have explored the typical cases of abusive and unjustified demands on guarantees in the construction industry, and how the different jurisdictions have evolved and developed legal responses to such instances. It is hoped that the structural approach employed, which grouped instances of potentially abusive calls on a guarantee into two main categories, and presented negative stipulations in a separate additional chapter, may contribute towards helpful systematisation of the different aspects of abusive calls and, most importantly, foster a better understanding of the law relating to demand guarantees.

Chapter Eight: Recommendations and measures to counter abusive calls on demand guarantees in the construction context

8.1 Introduction

Demand guarantees are popular and established instruments of security used generally in commercial dealings, and particularly in the construction industry. This was discussed in the first four chapters. However, as emerged from Chapters Five to Seven, they can be abused by unscrupulous and dishonest beneficiaries who take advantage of the abstract nature of the instruments. Therefore, members of the construction industry are well-advised to consider measures to reduce the risk of unfair calls and to limit the potential of abusive conduct by beneficiaries. This is the main focus of this concluding chapter.

Naturally, the most effective way to avoid negative financial implications due to abusive calls on guarantees is to be found in prevention.[1] This would entail investigating the contractual party sufficiently before entering into a contract,[2] imposing specific procurement requirements, and estimating and predicting the risks of unfair calls.[3] Based on such an analysis the risk of unjustified calls, and the respective negative financial consequences, could be addressed during the contracting stage by adjusting the contract price accordingly. Such an investigation should include the solvency and financial standing,[4] the company structure, and the history of the manner in which the party concerned has conducted business in the past.[5] For instance, it has been suggested, as a general rule, that beneficiaries who are "reputable institution[s]" and "government department[s]" pose a reduced risk of calling-up a guarantee unfairly.[6] Part of this risk assessment could include the occurrence and frequency of calls on demand guarantees in the past, and if so the circumstances pertaining to them.

[1] This is based on the premise that demand guarantees play too critical a role in construction to refrain from utilising them altogether. See par 4.4 above.

[2] Kelleher, Mastin and Robey *Smith, Currie and Hancock's Common Sense Construction Law* (2015) 249 *et seq*.

[3] Graf von Westphalen and Zöchling-Jud *Die Bankgarantie im internationalen Handelsverkehr* (2014) 638 par 141-142.

[4] For example, Bailey writes that "[t]he financial stability of the parties to a construction or engineering contract is usually a matter which is critical to the success of the project" (*Construction Law Volume III* (2011) 1391 par 22.01 (alteration by me)).

[5] Schütze and Edelmann *Bankgarantien* (2011) 33 state that the risk of abusive conduct associated with demand guarantees necessitates that the beneficiary must be sincere and solvent ("Angesichts der Gefährlichkeit einer Garantie 'auf erstes Anfordern' kommt es in gesteigertem Maßen auf die Bonität und Seriosität des Begünstigten […] an" – omission by me).

[6] Graf von Westphalen and Zöchling-Jud (n 3) 642 par 159 (alterations by me). However, in this particular regard, attention should be devoted to inept, if not dishonest conduct of a government department as emerges from the judgment by Satchwell J in *Group Five Construction (Pty) Limited v Member of the Executive Council for Public Transport Roads and Works Gauteng* [2015] ZAGPJHC 55 (13 February 2015) par 53-54.

However, such a thorough investigation before entering into a contractual relationship is not always feasible, sufficient or appropriate.[7]

It is accordingly suggested that the problem of abusive calls should be addressed differently, at least in addition to preventative scrutiny and prior risk assessment. Four main aspects have been identified in this regard which merit further analysis, namely: (i) contract administration; (ii) the drafting of underlying contracts and bespoke guarantees; (iii) the use of standard-form guarantees; and (iv) the availability of provisional or interim court relief. These issues are dealt with below.

Before dealing with these four aspects, however, two further issues deserve consideration. Although they do not contribute to limiting the instances of potential abuse of demand guarantees in the construction industry, it is submitted that they nevertheless hold significant merit. In the first place, it is important that all parties active in construction and international trade are aware of the underlying mechanisms and possible risks when opting for the utilisation of demand guarantees. If they are cognisant with, sufficiently educated in, and mindful of the legal principles and consequences coupled to the use of these instruments, they are better equipped to assess meaningfully their advantages and disadvantages in a particular project, and, concomitantly, to make sound business decisions, and avoid pitfalls and legal uncertainty. Secondly, it is important to take note of the fact that insurance companies offer products to mitigate and reduce the financial risks brought about by unfair and abusive calls on demand guarantees, the so-called "bad call insurance".[8] While these insurance contracts do not counter the abuse itself, they indemnify against, or at least mitigate the consequential financial loss pursuant to, abusive demands. For parties active in the construction industry, it may be particularly comforting in certain situations to know that they are insured against the financial risk of abusive demands.[9]

[7] See the remarks of Graf von Westphalen and Zöchling-Jud (n 3) 638 par 142. Another issue in this regard could be confidentiality agreements. See Adams "New clots in the life-blood of international construction projects: enjoining employers' calls on performance bonds" 2014 *Construction Law Journal* 325 334-335.

[8] See par 4.4 above.

[9] However, such insurance policies will, naturally, increase the overall costs of the transaction.

8.2 Contract management and conciliation

Contract management, contract administration and supervision are well-known processes in construction involving complex projects, as well as prolonged planning and execution phases.[10] The employer usually engages an engineer, architect or otherwise qualified construction professional to assess the design of the structure or project, supervise the construction site and activities on the premises, the different parties involved (main contractor, subcontractors if any, suppliers, independent construction experts and so forth), their conduct and the works and its progress or lack thereof.[11] Complex construction entails an ongoing relationship, potentially bringing about unforeseen developments leading to unexpected disruptions, additional work, delays and thus costs, liquidity problems for parties involved and so forth. Therefore, scholars argue that "[t]he best way to handle claims is to anticipate them and avoid them to the extent possible".[12]

Contract management and administration is therefore of utmost importance for all parties involved. Only by prudent and meticulous supervision is the employer able to identify possible issues before they arise and escalate, for instance delays, defective workmanship or abandonment of the construction site by contractors. But the contractor is also well-advised to appoint a construction expert should difficulties surface, as a call on a construction guarantee can occur as soon the employer perceives the executed work to be incomplete or of inferior quality. Should disputes come to the fore, cooperation, conciliation and dialogue between the employer and contractor are probably the most effective and efficient dispute avoidance or resolution method; emphasis should be placed on the encouragement to identify potential problems and difficulties as early as possible, and to settle and resolve disputes amicably before any relationships break down.[13]

It has been said, moreover, that "[w]hile claims and disputes remain inevitable, proactive dispute management can lead to quick resolution and more rewarding use of

[10] Chambers *Hudson's Building and Engineering Contracts* (2010) 309-321 par 2-096-2-106; Bailey *Construction Law Volume I* (2011) 294 par 5.01 *et seq*; and Klee *International Construction Contract Law* (2015) 4 par 1.4 *et seq*.

[11] Hughes, Champion and Murdoch *Construction Contracts Law and Management* (2015) 283; Furst and Ramsey *Keating on Construction Contracts* (2012) 473 par 14-016; and Uff *Construction Law* (2013) 291-292.

[12] Kelleher, Mastin and Robey (n 2) 431 (alteration by me).

[13] Kelleher, Mastin and Robey (n 2) 447-448; and Klee (n 10) 205 par 10.1. Rubin, Fairweather and Guy *Construction Claims Prevention and Resolution* (1999) 3, for example, speak of "cooperative project management".

resources".[14] This should be borne in mind when identifying and applying techniques and measures aimed at resolving disputes in the construction environment. Such measures can include, for example, the process of adjudication[15] or mediation. Some jurisdictions provide for statutory adjudication of construction disputes,[16] or recognise and encourage the forming of agreements to refer disputes to adjudication.[17] The adjudicator's decision is (usually) not binding as either party is free to reject the decision and proceed to arbitration or litigation.[18] Often, however, the dispute is resolved by the adjudicator's decision. Mediation as a conciliatory exercise involving "a neutral mediator finding middle ground between the position of the parties with the aim of achieving a negotiated solution acceptable to all parties",[19] may also prove worthwhile in order to avoid or resolve construction disputes amicably before they escalate.[20]

8.3 Specific clauses: drafting of the underlying contract and bespoke guarantees

The danger of abusive demands on abstract payment instruments in the construction context should also be approached from a different perspective. While diligent contract management and continuous conciliatory efforts will help in many instances to avert improper calls, this is not always so. For this reason, *inter alia*, the drafting of the underlying construction contract

[14] Rubin, Fairweather and Guy (n 13) 3 (alteration by me).

[15] For adjudication directly relating to the call on the guarantee itself, see par 8.3 immediately below.

[16] Coulson *Coulson on Construction Adjudication* (2015) 15 *et seq*; Furst and Ramsey (n 11) 684-687 and 695-696; Uff (n 11) 67 *et seq*; Adriaanse *Construction Contract Law* (2010) 356-357; Redmond *Adjudication in Construction Contracts* (2001) 39 *et seq*; Chambers (n 10) 1435-1450 par 11-053 *et seq*; Garner *JBCC 2014 and all that* (2014) 149; and Bailey (n 4) 1453 *et seq*. See Eschenbruch "Aktuelle Entwicklungstendenzen im deutschen Bauvertragsrecht" in Kapellmann, Franke and Grauvogl *Geheimnisse des Baugrunds Festschrift für Klaus Englert* (2014) 47-48 for highly critical remarks in this regard.

[17] Adriaanse (n 16) 361; Chambers (n 10) 1377-1378 par 11-007; and Coulson (n 16) 145 *et seq*.

[18] Bailey (n 4) 1503 par 24.77 and 1507 par 24.85; Furst and Ramsey (n 11) 723 par 18-053; Chambers (n 10) 1376 par 11-006; Weselik and Hamerl *Handbuch des internationalen Bauvertrags* (2015) 34; Simmonds *Statutory Adjudication* (2003) 3 par 1.1; Garner (n 16) 149; Riches and Dancaster *Construction Adjudication* (2004) 16 and 264; and Redmond (n 16) 150-152.

[19] Uff (n 11) 64.

[20] Bailey (n 4) 1427 par 23.15; Brand, Steadman and Todd *Commercial Mediation* (2012) 24 *et seq*; and Loots *Construction Law and Related Issues* (1995) 1011-1014.

and the demand guarantee can become very important. Bailey[21] has described the beneficiary's right to draw under an abstract payment instrument as follows:

> "[T]he circumstances in which the beneficiary […] may be entitled to make a demand for payment *under the instrument* are to be determined from the instrument, and not from the terms of any underlying contract between the beneficiary and a third party (eg, the construction contract pursuant to which the security was provided)."

It is accordingly of the utmost importance to pay close attention to the wording and composition of the actual terms of the guarantee; it essentially defines the claim of the beneficiary – and also potential defences to such a demand if the terms of the instrument provide for that.[22] However, as the research in the previous chapters has shown,[23] there is a legal nexus between the underlying construction contract, and the guarantee. Although generally independent and abstract, certain instances may qualify or restrict the right to call up the guarantee. As a consequence, the drafting of the underlying construction contract can also be very important in this context.[24] It forms, after all, the backbone of the relationship between the employer and the main contractor.[25]

Should the parties opt for a standard-form construction contract, the same note of caution applies. The construction industry has developed several popular standard-form construction contracts, with contract forms tailored to suit specific types of construction and engineering projects depending on their size and nature, and it is important that the proper one should be selected.[26] Any guarantee issued and utilised later during the construction process should, ideally, be described properly and in sufficient detail in the underlying contract. Scholars point out that "[…] attention must be paid not only to the drafting of the bond, but also to the underlying contract, AND to making sure that those two documents

[21] *Construction Law Volume II* (2011) 915 (omission and insertion by me). Note, however, the remarks relating to so-called negative stipulations below and, in particular, in chapter 7 above.

[22] See chapter 6 above.

[23] See chapters 5-7 above.

[24] Some scholars caution against making use of bespoke construction contracts in general see Forward "NEC3 compared and contrasted with JCT 2011" in Forward *NEC3 Compared and Contrasted* (2015) 1 7 ("There is clearly no such thing as a perfect standard form building contract for a particular project, but this knowledge should be balanced against the experience with entirely bespoke forms of building contract not generally being favourable"). For the advantages of utilising standard-form contracts, see par 2.6 *et seq* above.

[25] For example, Ellinger and Neo *The Law and Practice of Documentary Letters of Credit* (2010) 330 par IV describe the underlying contract as "the basis" for any subsequent demand guarantee.

[26] For the many standard-form construction contracts, see par 2.6 *et seq* above.

support, and are consistent with, each other".[27] Therefore, the parties need to consider carefully, in the underlying construction contract, their expectations, and the wording and configuration of any demand guarantee required. Naturally, the guarantee itself must then be drafted to give effect to any agreement reached by the parties in this regard.[28]

It is especially important that the parties express their intention to create a truly independent and abstract guarantee clearly and unambiguously,[29] so as to avoid disputes concerning the nature of the instrument.[30] Consideration should also be given to the proper description of the events which qualify for a demand,[31] and the specific documents required for a valid demand. Adodo advises applicants to ensure that "appropriate documents" are called for as a "primary line of protection" in abstract payment instruments.[32] He elaborates on appropriateness in this context as follows:

> "What counts as 'appropriate documents' depends on how much trust he [the applicant] could put in the beneficiary. Documents of that kind may well be certificates of inspection, quality, and quantity issued by a person of sufficient professional integrity […], but should not be one issued by the beneficiary himself or a third party under his influence or the applicant's undoubted control. In the case of a credit planned to be security to guarantee the repayment of a loan, or the faithful discharge of other contractual obligation [sic], the protection may involve stating in the application form that, in order to draw down the amount of the credit, the beneficiary is to obtain from a designated responsible body, a certificate affirming the applicant's default on his obligation."[33]

Adodo's remarks primarily referred to letters of credit, but it is suggested that they are similarly applicable to demand-guarantee transactions in the construction industry. The parties should consider carefully the types of documents required under the guarantee. This must be done mindful of the fact that certain documents will require more effort from the beneficiary to collect, for a compliant presentation, than others. For example, the requirement for the beneficiary to submit a mere simple written demand, without any further conditions,

[27] Graf von Westphalen and Zöchling-Jud (n 3) 640 par 152 (omission by me, emphasis in the original).

[28] Graf von Westphalen and Zöchling-Jud (n 3) 618 par 57.

[29] Hugo "Construction guarantees and the Supreme Court of Appeal (2010 – 2013)" in Visser and Pretorius *Essays in Honour of Frans Malan* (2014) 159 173; and Bertrams *Bank Guarantees in International Trade* (2013) 89 par 8-2.

[30] See par 3.2.4, and par 4.5.2 above.

[31] Hugo (n 29) 173; and Spaini *Die Bankgarantie und ihre Erscheinungsformen bei Bauarbeiten* (2000) 141-142 par 2.

[32] Adodo *Letters of Credit the Law and Practice of Compliance* (2014) 30 par 2.06.

[33] (n 32) 30 par 2.06 (alterations, insertions and omission of his footnote by me).

would represent one extreme end of a possible spectrum.[34] Equipped with such an instrument, occasionally referred to as a "suicide letter",[35] the beneficiary will be able to claim under the guarantee with great ease, as a mere demand in writing will be sufficient.[36] In this case the applicant would be well-advised to ensure that the guarantee includes at least a provision requiring the beneficiary to identify the basis of the demand,[37] either by inserting an express provision into the guarantee to this effect, or by subjecting the guarantee transaction to the URDG 758.[38] The beneficiary will then be required to make a statement in writing relating to a fact (for example breach of contract), enabling the applicant to investigate the alleged breach. This may disclose that the statement is clearly wrong and that the beneficiary has made it knowing that it is untrue – which would open the door to the fraud exception (in South African and English law) or the *Rechtsmissbrauch* doctrine (in German law) and enable the applicant to interdict payment.[39]

From the applicant's point of view it is preferable to insist on further documentary requirements that must be incorporated into the guarantee. Enonchong[40] writes:

> "Documentary protection may also be secured by the requirement of other documents to be issued by the account party himself [the applicant] or by the beneficiary. The extent to which the risk of fraud is reduced by a documentary requirement may depend on whether the document is to be signed by the account party [the applicant], an independent third party, or the beneficiary. In principle the level of risk is lowest where the required document is to be signed by the account party himself and highest where the document is to be signed by the beneficiary alone."

The imposition of the specific documentary condition for payment under the guarantee, which calls for a statement by the *applicant* confirming the entitlement, offers the most reliable measure against abusive calls, but will seldom be acceptable to a beneficiary.[41] Such a requirement would effectively make any demand on the guarantee conditional upon approval by the applicant – a notion which is in conflict with the fundamental purpose of demand guarantees. Less severe, but still running counter to the purpose of the guarantee to

[34] Andrews and Millett *Law of Guarantees* (2011) 616 par 16-001; and Malek and Quest *Jack: Documentary Credits* (2009) 353 par 12.44.

[35] Enonchong *The Independence Principle of Letters of Credit and Demand Guarantees* (2011) 144 par 5.127.

[36] Graf von Westphalen and Zöchling-Jud (n 3) 622 par 66 as well as 639-640 par 149.

[37] Malek and Quest (n 34) 378 par 12.87.

[38] See, especially, Art15(a) URDG.

[39] See par 5.2 *et seq* above.

[40] (n 35) 137 par 5.109 (insertions by me).

[41] Enonchong (n 35) 138 par 5.111 and 5.112.

provide swift and certain access to money in cases of default (whether disputed or not), are documents such as a judgment or arbitral award confirming the breach of the underlying obligation.[42] Documents that are more in harmony with the purpose of the guarantee are a notice of cancellation of the underlying (construction) contract, a court order reflecting the liquidation of the contractor,[43] or a document by an independent third party affirming the presence and extent of damages suffered, or payments due.[44] In the construction context, this is likely to be a certificate by an engineer or construction professional substantiating the breach or certifying the entitlement to payment.

The problems that may arise because of imprecise or improper identification of parties in the guarantee and the underlying agreement have been explored above.[45] They underscore the importance of the guarantee and the construction contract containing the full and precise names and correct identities of all parties involved in the guarantee transaction.[46] Ambiguity and discrepancies in the different documents (the underlying construction contract and the demand guarantee) should be avoided when referring to any of the parties concerned. Furthermore, there should be clarity on the position in the event of any of the parties undergoing a merger, change in company structure or being succeeded.[47] The expression of a clear consensus in this regard will go far in assisting judges or arbitrators in any dispute should a change to the legal structure or the identity of a party occur.

Moreover, the underlying contract should call for, and the guarantee should indicate clearly, the maximum amount of the guarantee, its expiry date[48] and, if appropriate and so agreed, a reduction or variation clause.[49] The operation of a reduction or variation clause diminishes the exposure of the guarantor and applicant with progression of the work in the

[42] Graf von Westphalen and Zöchling-Jud (n 3) 638 par 140; Andrews and Millett (n 34) 616. Note that such a requirement was seen as one of the main reason for the failure of the URCG 325. See par 3.2.1 above.

[43] See, for example, *Compass Insurance v Hospitality Hotel Developments (Pty) Ltd* (756/10) [2011] ZASCA 149 (26 September 2011).

[44] Andrews and Millett (n 34) 616 par 16-001 and 650 par 16-020; Adodo (n 32) 30 par 2.06; and Malek and Quest (n 34) 353 par 12.45. See also Hellner and Steuer *Bankrecht und Bankpraxis* (2006) par 5/271 for the importance of providing for third-party document submission.

[45] See par 6.3 *et seq* above.

[46] Bertrams (n 29) 93 par 8-6.

[47] See par 6.3 *et seq* above.

[48] However, take note of the problem of extend-or-pay demands (par 5.9 above). See par 5.9 and 6.4 for the issue of expiry dates and their enforcements in some jurisdictions.

[49] See par 4.3.1 and par 6.5 above on reduction and variation clauses.

case of a performance or warranty guarantee. Potential exposure is limited and restricted to an amount more in correspondence with the anticipated damages.

A notice requirement, obliging the beneficiary to inform the applicant of an intended call in advance, can also curb the abuse of demand guarantees.[50] Such notification provides the applicant with more time to investigate the alleged facts (breach of the contract, liquidation of a party, or whatever the beneficiary's statement may contain) comprehensively. The additional time may be utilised by the applicant to attempt to resolve the dispute amicably,[51] and thereby potentially preventing the calling up of the guarantee, or to gather evidence to prove the abusive nature of the anticipated demand and seek an injunction against the beneficiary, preventing the submission of the demand.[52] It should be borne in mind, however, that the purpose of the guarantee is typically to provide swift access to money for the beneficiary. This is incompatible with a long advance-notice period.

Negative stipulations in the underlying contract, qualifying or excluding the beneficiary's right to call up the guarantee in specific circumstances, or making it conditional upon a certain event or conduct, have also proved to offer protection against abusive demands in some jurisdictions.[53] Negative stipulations should be clear and express: courts are not likely to accept the existence of a tacit negative stipulation.[54] It must be noted that negative stipulations are, overall, controversial and treated differently by the jurisdictions examined in this thesis.

Furthermore, the applicant may benefit from the inclusion of a stipulation which requires the demand to be strictly in conformity with specific wording set forth in the guarantee. To be compliant, a demand may then have to coincide more meticulously with the requirements in the guarantee, and bind the beneficiary to a very precise and particular statement. A different, deviating statement will open the door for a defence of non-

[50] See Hugo (n 29) 173; and Dunham "The use and abuse of first demand guarantees in international construction projects" 2008 *The International Construction Law Review* 273 279.

[51] See par 8.2 above.

[52] Enonchong (n 35) 143 par 5.125. Also, see par 3.4.2.6 and par 5.2 *et seq* above.

[53] See chapter 7 above.

[54] See, for instance, the discussion of *Kwikspace Modular Buildings v Sabodala Mining Company* (173/09) [2010] ZASCA 15 (18 March 2010) in par 7.2 and 7.5 above.

conformity,[55] and, if a conforming statement is made by the beneficiary in the knowledge that it is incorrect, the fraud exception or the doctrine of *Rechtsmissbrauch* may be available to defeat the demand for payment.[56]

Moreover, by a provision which clearly requires *strict* documentary compliance, the intentions of the parties can be made plain – this is especially relevant in jurisdictions where courts investigate the parties' intentions in order to establish the applicable degree of strictness.[57] Such a provision could also clarify whether or not a demand by an agent of the beneficiary will be acceptable.[58]

An additional contractual measure to prevent abusive demands may be to require *adjudication* on the question whether or not the calling up of the guarantee is justified.[59] The obligation on the guarantor to honour the guarantee is then suspended for a relatively short period of time, and becomes conditional upon a favourable outcome of the adjudication.[60] This, naturally, depreciates the guarantee of some of its commercial value from the beneficiary's perspective, since the applicant is empowered to prevent payment with ease (albeit temporarily) by referring the matter to adjudication. Hence, for many prospective beneficiaries such a provision will be unacceptable.

Finally, it is advisable that the underlying construction contract and the demand guarantee contain clauses relating to the applicable law (a choice-of-law clause) and set of rules (whether the URDG, the ISP98 or any other rules apply), jurisdiction and competent forum.[61] This would contribute significantly to legal certainty. In the course of the research, the differences in approach offered by South African, English and German law have been explored and analysed. Although in many respects offering similar or comparable solutions to

[55] See par 6.2.2 above.

[56] See par 5.2 *et seq* above.

[57] See par 6.2.3 *et seq* above.

[58] See par 6.3 *et seq* above.

[59] Dixon, Gösswein and Button "On-demand performance bonds in the international market and adjudication as a means of reducing the risks" 2005 *The International Construction Law Review* 284 286-288.

[60] Dixon, Gösswein and Button (n 59) 286-288 reported on a case which concerned a period of time of 28 days.

[61] In this regard, see Enonchong (n 35) 299 *et seq*.

instances of abusive calls, there are certain crucial differences.[62] If the parties wish to benefit from certain legal approaches or exceptions to the principle of independence, an appropriate choice-of-law stipulation is advisable. It can also be crucial in determining whether the guarantee is independent or accessory. As stated by Klee:

> "By agreement of the parties, bank guarantees can be made subject to any governing law. Selection of law must always be considered carefully, as not all legal systems define the guarantee in such an abstract form and only know the concept of suretyship."[63]

Therefore, the selection of a specific legal system to govern the guarantee transaction, or a particular set of rules,[64] can have far-reaching consequences.[65] To illustrate, one may appreciate articles 19 and 20 of the UNCITRAL Convention,[66] which expressly permit provisional court measures in serious cases of abusive conduct by the beneficiary. The URDG 758, on the other hand, have the advantage that the beneficiary is obliged by default (Art15 (a)) to attach a statement elaborating in what respect the purported breach occurred, which may increase the applicant's chances to succeed with the fraud defence. Kelly-Louw,[67] in regard to the different available international sets of rules for guarantees, concludes:

> "It follows that if market participants want strong protection against fraud, they should incorporate the URCG [325]; if they desire moderate protection, they should incorporate the [UNCITRAL] Convention; and if they only want minimal protection, they should incorporate the URDG [758]."

The essential point is that a contractor (or any other applicant who is required to provide a guarantee payable on demand) can, by devoting careful attention to the drafting of the underlying contract and the guarantee, gain significant protection against abusive calls. Gaining these advantages, however, will necessarily depend on the available bargaining power and negotiation skills of the respective parties.

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[62] See the comprehensive analysis of the different instances of abusive and impermissible conduct in chapters 5-7 above dealing with, most importantly, fraud, the final determination of the underlying disputes and negative stipulations.

[63] (n 10) 378 par 16.5.

[64] For example the URDG 758, the ISP98 or the UNCITRAL Convention. See par 3.2 *et seq* above.

[65] Graf von Westphalen and Zöchling-Jud (n 3) 638 par 143 ("The impact of local laws and practices should not be ignored either").

[66] On the UNCITRAL Convention see par 3.2.3 above.

[67] "International measures to prohibit fraudulent calls on demand guarantees and standby letters of credit" 2010 *George Mason Journal of International Commercial Law* 74 120 (insertions by me). On the URCG 325 and the URDG 758 see par 3.2.1 above; on the UNCITRAL Convention see par 3.2.3 above.

8.4 Standard-form guarantees

The use of standard-form guarantees is widespread in the construction industry, and can entail certain advantages for all parties concerned.[68] Naturally, the process of negotiating the individual terms of the guarantee falls away, leaving the parties merely to settle for one of the many available guarantee forms.[69] In regard to legal certainty, standard-form guarantees may benefit from their familiarity within the industry and amongst the judiciary and arbitrators.[70] This is similar to standard-form construction contracts, with which many construction professionals, judges and arbitrators are well acquainted. This reduces the risk that the person or body involved (construction professional, court of law or arbitral tribunal) may misconstrue provisions of the guarantee, or be unfamiliar with terminology and legal mechanisms referred to in them. This is especially important in regard to the independent nature of the guarantor's undertaking. The JBCC performance guarantee (construction guarantee), for example, has been analysed and considered in several South African cases,[71] leading to a noticeable familiarity with the specific provisions and the document in general.[72]

Standard-form guarantees avoid references to non-documentary requirements, and contain only appropriate documentary conditions. Further, they often provide specifically for reduction or variation clauses, which incrementally reduce the exposure of the guarantor as the execution of the contract advances.[73] Some forms contain a provision which subjects the guarantee to the URDG 758 by default,[74] and so contribute to legal certainty.

[68] See also par 4.2 above.

[69] Examples are the many JBCC standard-form guarantees (*inter alia* MWA, NSSA or PBA guarantees), or the "almost identical" GCC standard-form guarantees (Hugo (n 29) 165). FIDIC also offers standard-form guarantees. See Klee (n 10) 383 par 16.9; and Affaki and Goode *Guide to ICC Uniform Rules for Demand Guarantees URDG 758* (2011) 438 par 599. Note, however, the remarks of MacRoberts *MacRoberts on Scottish Construction Contracts* (2015) 487 par 23.1.2 ("Despite the frequent use of guarantees, few of the institutions responsible for promoting standard forms of construction contracts have published standard forms of guarantee (other than for performance bonds), so it is left to the parties to devise their own wording").

[70] See the remarks by Garner (n 16) 30.

[71] For instance, *Granbuild (Pty) Ltd v Minister of Transport and Public Works, Western Cape* [2015] ZAWCHC 83 (5 June 2015); and *Dormell Properties 282 CC v Renasa Insurance Co Ltd* 2011 (1) SA 70 (SCA).

[72] Hugo "Bank guarantees" in Sharrock *The Law of Banking and Payment in South Africa* (2016) 437 439-440; and Garner (n 16) 30.

[73] To use an example from a South African context, the *JBCC (Minor Works Agreement) Construction Guarantee* provides a simple and effective reduction mechanism (clauses 1.1.1-1.1.3).

[74] See Hugo (n 29) 165-166 (reference to FIDIC and URDG 758); and Dunham (n 50) 275 (reference to FIDIC and the previous URDG 458).

The standard-form guarantees are, of course, not cast in stone; they can be modified or added to.[75] In this context one may consider the fact that some standard-form guarantees contain minimal conditions for triggering payment.

In the case of the "JBCC (Minor Works Agreement) Construction Guarantee", for example, the beneficiary must only submit a demand in writing (clause 5.0) and a copy of the contract termination notice sent out previously to the contractor for alleged breach of the underlying contract (clause 5.1). Nothing prevents the parties from adding further conditions that may address the particular concerns in a specific case. However, bearing in mind the complex legal environment of construction guarantees, when amending or adding to a standard-form contract the parties should only do so on the basis of competent legal advice.[76]

8.5 Provisional court measures

Demand guarantees are designed and drafted to ensure prompt access to financial means in cases of default and dispute. If a beneficiary tenders conforming documents to the guarantor, the guarantor is expected to honour the promise and pay without delay. Banks as guarantors are usually inclined to comply with a demand in order to avoid legal disputes with the beneficiary, and to preserve the general trust in their ability and willingness to honour their contractual promises.[77] Therefore, if the applicant suspects the demand to be abusive and unjustified, it should act quickly if it wishes to interfere with the payment process. In previous chapters,[78] the typical instances of abusive or otherwise impermissible conduct relating to demand guarantees in the construction industry are identified, assessed and explored. The legal approaches adopted by the different jurisdictions (South Africa, England, and Germany) are analysed and compared. Provisional court measures, injunctive relief and interim interdicts are often the applicant's only remedy to counteract abuse of a demand guarantee.[79]

[75] Note, however, the previous elaborations in regard to alterations of standard-form contracts, par 2.6.1 above.

[76] n 75.

[77] Mahler *Rechtsmißbrauch und einstweiliger Rechtsschutz bei Dokumentenakkreditiv und 'Akkreditiven auf erstes Anfordern'* (1986) 101; and Dunham (n 50) 279.

[78] See chapters 5-7 above.

[79] See par 3.4.2.6 above for an introduction to this issue.

An applicant that wishes to resort to the courts to obtain an urgent provisional (and eventually final)[80] interdict to prevent the demand or the paying-out of the guarantee, must consider against which party it wishes to proceed (the beneficiary, the guarantor or both).[81] This depends on the applicable legal system and the specific type of abusive conduct. For instance, a negative stipulation in the underlying contract restricting the right to call on a demand guarantee, if recognised by the respective jurisdiction, is best enforced by interdicting the beneficiary from submitting a demand, or compelling it to withdraw it should it already have been made.[82] Documentary fraud, on the other hand, is probably most effectively opposed by alerting the guarantor of the fraudulent conduct, and by seeking an interdict against the beneficiary (preventing presentations of falsified documents) and potentially also the guarantor (barring it from honouring the abusive demand). The availability of, and requirements for, provisional and final relief will depend on the applicable law.[83] Hence, as stated above,[84] a well-considered choice-of-law clause can be very important.

8.6 Concluding remarks

The research conducted for this thesis has investigated the use and abuse of demand guarantees in the construction industry. The first part of the thesis, Chapters One to Four, introduced the general construction context, the use of demand guarantees in commercial transactions and the law relating to it, as well as the use of guarantees specifically in construction and possible alternative means of security. The analysis and comparison of the law of demand guarantees in South Africa, England and Germany in the subsequent part of the thesis, Chapters Five to Seven, has shown the typical instances of abusive calls on guarantees in the construction industry, and the respective legal mechanisms dealing with these cases.

[80] On the different requirements, see par 3.4.2.6 above.

[81] Proctor *The Law and Practice of International Trade* (2015) 508-509 par 24.66 *et seq*.

[82] Under German law, however, the answer could conceivably differ in some instances as was pointed out. See par 7.4 and 7.5 above.

[83] An introduction to this issue is provided in par 3.4.2.6 above.

[84] See par 8.3 above.

In order to systematise[85] the different cases of abusive behaviour, it was distinguished between (i) conduct which is abusive with reference to the underlying contract,[86] and, (ii) instances in which the abuse and potential defences relate directly to the guarantee and its terms.[87] Due to the deviating and complex legal responses in the different jurisdictions, the important issue of negative stipulations was dealt with extensively in a separate, additional chapter.[88]

The jurisdictions under examination have developed and established legal responses to most cases of abusive conduct, most notably the fraud exception and its contemporary interpretation in English and South African law, and the German doctrine of *Rechtsmissbrauch (*also referred to as *Rechtsmissbrauchsverbot).* On the other hand, the independence principle is well-established and recognised in the different legal systems, and exceptions to the autonomous nature of guarantees are only permitted in instances of clear and serious abuse. Furthermore, the terms of the guarantee may also provide valid defences in certain instances. This much is evident from the research presented in Chapters Five to Seven.

Despite the seemingly numerous situations in which grossly unfair calls on demand guarantees may typically occur, the utilisation and inclusion of guarantees into construction contracts is still advantageous and recommended. As pointed out above, only demand guarantees offer assured and swift access to cash when construction defects emerge, payment is outstanding, or a construction party becomes insolvent or is liquidated. At the same time, demand guarantees are relatively simple instruments, versatile and internationally-accepted, and do not necessarily require the applicant to deposit cash or otherwise tie up capital whilst in operation. Therefore, demand guarantees are an indispensable feature in construction contracts of certain complexity and value.

This research in general and the recommendations and measures presented in this last chapter, will hopefully contribute towards the proper use of, and the preventing of the abuse

[85] See the explanations in par 1.5 and 5.1 above.

[86] See chapter 5 above.

[87] See chapter 6 above.

[88] See chapter 7 above.

of, demand guarantees in the construction industry, thereby enhancing their value in the (international) construction environment.

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