DEMAND GUARANTEES AND THE PRINCIPLES OF THE FRAUD DEFENCE

Guardrisk Insurance Company Ltd v Kentz (Pty) Ltd

The law underlying the avoidance by a Guarantor of its obligations to make payment to a beneficiary under a demand guarantee is clarified and reaffirmed by the most recent ruling by the Supreme Court of Appeal in the case of Guardrisk Insurance Company Ltd vz Kentz (Pty) Ltd.

Two construction guarantees (on demand guarantees) that were issued by Guardrisk, in favour of the Kentz, at the behest of Brokrew Industrial (Pty) Ltd (Brokrew). Kentz was one of the contractors involved in the construction of a new power generation plant, the Medupi Power Station, for Eskom.

During September 2008, Kentz entered into a construction contract with Brokrew relating to the supply of ducting at Medupi. Brokrew was obliged to secure *"an irrevocable, on demand bank guarantee or a demand guarantee from a recognised financial institution"* for proper performance. This guarantee was referred to as the performance guarantee.

Kentz had paid Brokrew an amount of R17 million after an advance payment guarantee had been issued by Guardrisk and submitted to Kentz to facilitate commencement of the works by Brokrew, under the contract.

Brokrew experienced severe financial difficulties which impacted on its ability to perform its obligations under the construction contract. By 31 January 2010, Brokrew's liabilities exceeded its assets by more than R44 million. On 5 March 2010, Brokrew advised Kentz that unless the terms of the contract were renegotiated, it would not be in a position to perform its obligations in terms thereof.

On 24 February 2010 Kentz addressed a letter to Brokrew, confirming that Brokrew clearly had the intention not to continue with performance of its obligations under the Contract, had the intention to abandon the Contract and admitted to have become insolvent. In the alternatively, that Brokrew had, by its conduct, repudiated the contract which entitled Kentz to accept same and cancel the Contract. Brokrew was placed on terms to perform its obligations under the Contract. Later, on 9 March 2010, Kentz addressed a further letter to Brokrew cancelling the Contract with immediate effect.

On 11 March 2010 Brokrew's attorneys addressed a letter to Kentz, in which it disputed Kentz's entitlement to cancel the contract, recorded its contention that Kentz thereby repudiated the contract and accepted Kentz's repudiation of the contract whereupon it purported to cancel the contract. It also alleged that Kentz's call on the guarantees was fraudulent given the latter's knowledge that it was not entitled to cancel the contract.

Prior to the hearing of the matter in the high court, Brokrew was finally liquidated. The High Court found that the evidence had failed to establish that Kentz, in making demand for payment under the guarantees, had acted fraudulently. It further found that Guardrisk was obliged to make payment in terms of the guarantees and accordingly granted judgment in favour of Kentz.

The essential difference between the two types of bonds namely "on demand" or "call" bonds on the one hand and "conditional" on the other was described by Brand JA in *Minister of Transport and Public Works, Western Cape & another v Zanbuild Construction (Pty) Ltd & another* as follows:

> *"... [A] claimant under a conditional bond is required at least to allege and – depending on the terms of the bond – sometimes also to establish liability on the part of the contractor for the same amount. An "on demand" bond, also referred to as a "call bond", on the other hand, requires no allegation of liability on the part of the contractor under the construction contracts. All that is required for payment is a demand by the claimant, stated to be on the basis of the event specified in the bond."*

The Court found that the terms of the guarantees are clear and unambiguous. They create an obligation on the part of Guardrisk to pay Kentz on the happening of a specified event. It was recorded in the guarantees that, notwithstanding the reference in its wording to the construction contract, the liability of Guardrisk as principal is absolute and unconditional, and should not be construed to create an accessory or collateral obligation. The guarantees go further and specifically state that Guardrisk may not delay making payment in terms of the guarantees by reason of a dispute between the contractor and the employer. The purpose of the guarantees was to protect Kentz in the event that Brokrew could not perform its obligations in terms of the construction contract.

In *Lombard Insurance Co Ltd v Landmark Holdings (Pty) Ltd & others*, the Court described a guarantee very similar to the performance guarantee in this matter as:

> *"... not unlike irrevocable letters of credit issued by banks and used in international trade, the essential feature of which is the establishment of a contractual obligation on the part of a bank to pay the beneficiary (seller). This obligation is wholly independent of the underlying contract of sale and assures the seller of payment of the purchase price before he or she parts with the goods being sold. Whatever disputes may subsequently arise between buyer and seller is of no moment insofar as the bank's obligation is concerned. The bank's liability to the seller is to honour the credit. The bank undertakes to pay provided only that the conditions specified in the credit are met."*

The court found that the guarantees in this matter were unconditional and must be paid according to their terms. It confirmed our legal position that the only basis upon which Guardrisk can escape liability is to show proof of fraud on the part of Kentz.

Guardrisk also argued that each of the guarantees relied upon by Kentz requires that Kentz state that the amount claimed was payable to it in terms of the contract and that the Brokrew was in breach of its obligations under the contract. Guardrisk argued that the statements by Kentz in each of its demands to Guardrisk, to the effect that the amount claimed was payable to Kentz in terms of the construction contract with Brokrew, were material, knowingly false and constituted a fraud on both Kentz and Brokrew.

The legal position in relation regarding the fraud exception is 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 guarantor and decline enforcement of the guarantee in question. This fraud exception only 4applies where:

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

Furthermore, the party alleging and relying on such exception bears the onus of proving it. That onus is to be discharged on a balance of probabilities, and will not lightly be inferred. In the matter of *Loomcraft Fabrics CC* v *Nedbank Ltd & another* it was pointed out that in order to succeed in respect of the fraud exception, a party had to prove that the beneficiary presented the bills (documents) to the bank knowing that they contained material misrepresentations of fact upon which the bank would rely and which they knew were untrue. Mere error, misunderstanding or oversight, however

unreasonable, would not amount to fraud. Nor was it enough to show that the beneficiary's contentions were incorrect. A party had to go further and show that the beneficiary knew it to be incorrect and that the contention was advanced in bad faith.

The remarks made by Lord Denning MR in *Edward Owen Engineering Ltd* v *Barclays Bank International Ltd* to the effect that performance guarantees are virtually promissory notes payable on demand and very similar to letters of credit was relevant. In that case, Lord Denning added:

> *"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. The only exception is when there is a clear fraud of which the bank has notice."*

Guardrisk contended that the demands under the guarantees were fraudulent as Kentz had not given Brokrew adequate notice within which to remedy the breaches alleged by it. It was argued that Kentz had terminated the Contract prematurely and unlawfully.

It was common cause that during March 2010, Brokrew had informed Kentz that unless the terms of the building contract were renegotiated, it could not perform its obligations in terms of the building contract. The Contract included a clause which states that the employer shall be entitled to terminate the contract if Brokrew:

> *"abandons the Works or otherwise plainly demonstrates the intention not to continue performance of his obligations under the Contract . . . the Employer may, on notice to the Contractor, terminate the contract immediately."*

The Court found that Brokrew had clearly demonstrated its intention not to continue performing its contractual obligations and Kentz was entitled to cancel the building contract immediately, having reserved its rights in that regard previously.

The Court found that Guardrisk did not establish the fraud exception. In fact, what it sought to do is to have this Court determine the rights and obligations of the parties in relation to the construction agreement, which on the authorities, the Court was precluded from doing. The finding by the high

court that the appellants had not discharged the onus resting on them to establish fraud on the part of Kentz cannot be faulted. I agree with the reasoning of the high court that:

> "The evidence before court clearly demonstrates that Kentz held the view that it was entitled to *lawfully pursue its claims under the guarantees. The mere fact that it pressed its claims knowing that Brokrew held a contrary view about the cancellation with which it disagreed is not fraudulent."*

As already pointed out, a valid demand on an unconditional performance guarantee creates an obligation on Guardrisk to make payment in accordance with the terms of the guarantee. Mindful of that principle, the guarantor nevertheless urged the Court to have regard to the decision of the majority in *Dormell Properties282 CC* v *Renasa Insurance Co Ltd & others NNO*. It was submitted that the principles of practicality enunciated by the majority in that decision ought to be applied to the present matter and the issues concerning the rights and obligations of the parties to the construction contract should be determined as all the parties are before the Court and the disputes between Kentz and Brokrew have been crystallised and are capable of determination.

Our Courts, in a long line of cases, have strictly applied the principle that a bank faced with a valid demand in respect of a performance guarantee, is obliged to pay the beneficiary without investigation of the contractual position between the beneficiary and the principal debtor. One of the main reasons why Courts are ordinarily reluctant to entertain the underlying contractual disputes between an employer and a contractor when faced with a demand based on an on demand or unconditional performance guarantee, is because of the principle that to do so would undermine the efficacy of such guarantees. The Supreme Court of Appeal in *Loomcraft* referred to the fact that the autonomous nature of the obligation owed by the bank to the beneficiary under a letter of credit "*has been stressed by courts both in South Africa and overseas*". The learned judge referred to a number of authorities, both local and English to illustrate this point. Similarly, the Supreme Court of Appeal in *Lombard Insurance*, confirmed that the obligation on the part of the bank to make payment on a performance guarantee is independent of the underlying contract and whatever disputes may arise between the buyer and the seller are irrelevant as far as the bank's obligation is concerned.

This principle is based on sound reason. The very purpose of the guarantee is so that the beneficiary can call up the guarantee without having to wait for the final determination of its rights in terms of accessory obligations. To find otherwise, would involve an unjustified paradigm shift and defeat the commercial purpose of performance guarantees.

For these reasons, the appeal was dismissed with costs.

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