

**CONSTRUCTION GUARANTEES: FINALLY
CLOSING THE DOOR ON
EXTRANEIOUS DEFENCES**

***Coface South Africa Insurance Co Ltd v East
London Own Haven t/a Own Haven Housing
Association 2014 (2) SA 382 (SCA)***

1 Introduction

The issuing of performance bonds or construction guarantees in terms of a building contract may hold important consequences for the parties to a construction guarantee. Recently construction guarantees have received much attention from our courts and some of these cases even proceeding to the Supreme Court of Appeal (*Loomcraft Fabrics CC v Nedbank Ltd* 1996 (1) SA 812 (A); *Lombard Insurance Company Ltd v Landmark Holdings (Pty) Ltd* 2010 (2) SA 86 (SCA); *Dormell Properties 282 CC v Renasa Insurance Co Ltd* 2011 (1) SA 70 (SCA); *Minister of Transport and Public Works, Western Cape v Zanbuild Construction (Pty) Ltd* 2011 (5) SA 528 (SCA); *Casey v FirstRand Bank Ltd* 2014 (2) SA 374 (SCA); *FirstRand Bank Ltd v Brera Investments CC* 2013 (5) SA 556 (SCA); and *Guardrisk Insurance Company Ltd v Kentz (Pty) Ltd* (92/2013) [2013] ZASCA 182). There may be various reasons for this sudden escalation in litigation with construction guarantees as the subject matter. One of the reasons may be due to numerous major construction projects that have been undertaken in the last few years in South Africa. Notable examples of these major construction projects include the building of stadia for the 2010 FIFA Soccer World Cup, the Gautrian Project, and the Gauteng Freeway Improvement Project.

One of the aspects of construction guarantees that our courts has had to deal with was the nature of construction guarantees. The nature of construction guarantees is not only of academic interest but also has very important practical implications.

Building, engineering and construction contracts such as the family of New Engineering Contracts and The Joint Building Contracts Committee agreements make provision for the employer or the party commissioning the construction works ("the works") to place a contractual obligation on the contractor to furnish a construction guarantee. Shortly after the award of the construction contract ("the underlying contract"), the contractor will instruct its insurer or banker to issue such a construction guarantee to the benefit of the employer.

From the employer's perspective, the construction guarantee serves a dual purpose: firstly, the willingness of a financial institution or insurer to issue such a construction guarantee is, to a degree, an indication of the contractor's financial welfare. Secondly, in the event of the contractor's default, the construction guarantee enables the employer to gain immediate access to funds to properly complete the works in terms of the underlying contract (Kelly-Louw "Construction of Demand Guarantees Gone Awry: *Minister of Transport and Public Works v Zanbuild Construction*" 2013 25 SA Merc LJ 404 407).

A contractual relationship is created by the construction guarantee between the employer and the issuer thereof. When properly drafted, a construction guarantee entitles an employer to demand payment from the issuer unconditionally upon the occurrence of a specific event. The liability of the issuer of the construction guarantee is subject only to the employer complying with the terms and conditions contained in the construction guarantee (*Lombard Insurance Company Ltd v Landmark Holdings (Pty) Ltd supra* par 20). Normally, the employer is required to issue a certificate in terms of which it is confirmed that the contractor is in default of the building contract or underlying contract and therefore the employer demands payment in terms of the construction guarantee.

The main advantage that a construction guarantee offers to an employer is when enforcing the construction guarantee, the issuer thereof may not raise defences of an extraneous nature (Kelly-Louw 2013 25 SA Merc LJ 417). This prevents protracted litigation over complex factual disputes (Kelly-Louw 2013 25 SA Merc LJ 416). Fraud in such circumstances that makes it obvious is the only defence the issuer of a construction guarantee may raise to avoid liability under the construction guarantee (*Loomcraft Fabrics CC v Nedbank Ltd supra* 815–816; *Lombard Insurance Company Ltd v Landmark Holdings (Pty) Ltd supra* par 20).

However, the Supreme Court of Appeal in *Dormell Properties 282 CC v Renasa Insurance Co Ltd (supra)* reopened again the possibility of raising extraneous defences. The *Dormell* judgment caused much uncertainty on whether extraneous defences may be raised to avoid liability in terms of a construction guarantee. The confusion regarding the true legal position was further exacerbated by the fact that in subsequent cases involving construction guarantees, the Supreme Court of Appeal chose not to overturn the *Dormell* case but rather to distinguish the facts of subsequent cases from *Dormell* (*FirstRand Bank Ltd v Brera Investments CC supra* par 10).

This case note therefore deals with the latest reported judgment on construction guarantees delivered by the Supreme Court of Appeal in *Coface South Africa Insurance Co Ltd v East London Own Haven t/a Own Haven Housing Association* (2014 (2) SA 382 (SCA)). This case is of particular interest because the Supreme Court of Appeal unequivocally held that its judgment in *Dormell* was clearly wrong. This judgment has now once and for all put the question of whether or not extraneous defences may be raised in order to avoid liability under a construction guarantee to bed. The court also once again confirmed that the English doctrine of consideration does not form part of the South African law of contract.

2 Facts

East London Own Haven t/a Own Haven Housing Association (“the respondent”) instituted action against Coface South Africa Insurance Co Ltd (“the appellant”) claiming an amount of R1 172 583.80 (par 1). The respondent’s claim was based on a construction guarantee issued by the appellant on behalf of Construct Construction (Pty) Ltd (“the contractor”) (par 1). A building contract (“the contract”) was concluded between the respondent and the contractor in terms of which the contractor was required to complete certain specified construction works (“the works”) as described in the contract (par 1).

The contract placed an obligation on the contractor to deliver a construction guarantee to and in favour of the respondent (par 2). In line with this obligation, a construction guarantee was issued by the appellant and it was delivered to and accepted by the respondent (par 2). The terms of the construction guarantee provided that the appellant was under the obligation to make payment upon the receipt of the first written demand from the respondent calling for the construction guarantee (par 2).

The respondent cancelled the contract with the contractor due to the alleged default of the contractor and proceeded to take the necessary steps to enforce the construction guarantee against the appellant (par 3). In an attempt to avoid liability in terms of the construction guarantee the appellant denied that the respondent was entitled to cancel the contract (par 4). The appellant further alleged that the defective work was due to the faulty design provided by the respondent, and therefore the contractor has not defaulted on any obligations in terms of the contract (par 4). The respondent excepted to the defence raised by the appellant but the exception was dismissed by the South Gauteng High Court (par 5). After the dismissal of the exception, the appellant further sought an amendment to its plea which was opposed by the respondent (par 6). In the proposed amendments the appellant wished to rely upon a payment certificate confirming that the contractor does not owe any monies to the respondent (par 6). The appellant’s application to amend was dismissed by Lamont in the South Gauteng High Court (par 6).

The main question before the court of appeal was whether the appellant could rely upon the dispute between the respondent and contractor in respect of the entitlement of the respondent to cancel the underlying contract due to the default of the contractor as a defence to the liability of the appellant under the construction guarantee (par 24).

3 Judgment

The approach taken by the court in its judgment can basically be divided into three main themes, namely: the nature of construction guarantees; the *Dormell* judgment and case law since the *Dormell* judgment.

3 1 *The nature of construction guarantees*

In considering the nature of construction guarantees the court considered various English and South African judgments. By referring to the English case (par 10) of *Edward Owen Engineering Ltd v Barclays Bank International Ltd* [1978] 1 All ER 976 976 (CA) which dealt with the nature of a letter of credit, the court noted that the law requires that a letter of credit shall be honoured if the documents demanding payment are in compliance with the terms contained therein. The issuer of the letter of credit may not rely upon a dispute existing between the parties to the main or underlying contract to avoid liability (par 10). The issuer may avoid liability only in exceptional circumstances where it is obvious that fraud is present (par 10). A letter of credit may be equated to a performance-guarantee/performance bond or promissory note which is payable upon an honest demand (par 11).

By referring to *Loomcraft Fabrics CC v Nedbank Ltd (supra)* the autonomous nature of a letter of credit was stressed and the philosophy underlying a letter of credit was explained (par 12). The court in *Loomcraft* highlighted the significance and the role letters of credit play in commerce (par 12). The implications that may follow should the courts deviate from giving effect to letters of credit as if they were the equivalent of cash in hand was emphasised (par 12). It may lead to suppliers of goods and services being tentative or worse, even refusing to supply goods and/or services if uncertainty exists about the enforcement of payments under letters of credit (par 12).

Relying on *Lombard Insurance Company (Pty) Ltd v Landmark Holdings (Pty) Ltd (supra)*, the court (par 13) highlighted that the obligations of a letter of credit exist independently of any underlying contract. The issuer of a letter of credit is liable to honour the credit which has been given as long as the terms and conditions in the specific letter of credit have been met in the absence of fraud (par 13).

3 2 *The Dormell judgment*

In considering the *Dormell* judgment the court highlighted the fact that the judgment in the *Dormell* case deviated from preceding jurisprudence (par 14). Because the court in *Dormell* accepted the final arbitration award involving the parties to the underlying contract as a defence to the enforcement of a construction guarantee, the court opened the door for the reintroduction of “extraneous issues”, in certain circumstances, as a defence to claims or liability under construction guarantees.

3 3 *Case law since the Dormell judgment*

With regard to the question of whether a letter of credit is accessory to the underlying or principle contract, the court relied on *Casey v First National Bank Ltd* (2013 (4) SA 370 (GSJ) par 18). The court in the *Casey* matter held that a letter of credit should be distinguished from a surety contract (par 12 as quoted in par 18 of *Coface*). The main difference between a letter of

credit and a suretyship contract is that the liability under a letter of credit is not accessory to the underlying or principle contract (*Casey v First National Bank Ltd* supra par 14). The obligations in a letter of credit are independent from the principal debt (*Casey v First National Bank Ltd* supra par 14). Therefore the legal relationship between the parties in the underlying contract is irrelevant when considering the enforcement of the letter of credit.

The court (par 19) highlighted the fact that the court in *FirstRand Bank Limited v Brera Investments CC* (supra) favoured the minority judgment in *Dormell* judgment. The court pointed out that the court in *Brera* did not follow the judgment in *Dormell* as the case was distinguishable on the facts (par 19).

With reference to *Guardrisk Insurance Company Ltd v Kentz (Pty) Ltd* (supra) the court stressed that the liability of the issuer of a construction guarantee is absolute when it is unconditional (par 21). An unconditional guarantee stands independent of the underlying or principal contract (par 21). Payment of the guarantee may not be avoided by relying upon a dispute between the employer and the contractor under the underlying contract. It was also pointed out that the court in *Guardrisk* indicated its preference to the approach taken in the minority judgment of *Dormell* (par 22).

The court (par 23) criticised the approach followed in *Dormell*. Firstly, it was pointed out that *Dormell* relied on authority such as the *Cargill* case which involved the parties to the principal contract unlike the parties that were before the court in *Dormell* who were the parties to the construction guarantee. Secondly, the court in *Dormell* relied on authorities based on the English doctrine of consideration which is not part of South African law of contract (par 25).

To conclude, the court dismissed the appeal with costs (par 26).

4 Comments

This judgment makes it clear that there are substantial differences between a letter of credit and a surety contract (par 21). The contractual obligations in a letter of credit are autonomous and exist independently from any other underlying contract or contracts (par 20 and 24). When this principle is applied in its pure form, a letter of credit will be fully enforceable between the parties subject to the compliance with the terms of the letter of credit. Parties to a letter of credit are precluded from introducing extraneous factors such as, for example, a dispute between parties to an underlying contract (par 24). This is in sharp contrast with a surety contract, which is always accessory to an underlying or principle contract (*Minister of Transport and Public Works, Western Cape v Zanbuild Construction (Pty) Ltd* supra par 14); and *Kelly-Louw* 2013 25 SA Merc LJ 407). A surety is entitled to raise the same defences as the party for whom surety stood (usually the debtor in terms of a specific obligation) to the underlying contract (*Kelly-Louw* 2013 25 SA Merc LJ 407). Thus, extraneous defences may be introduced by the surety to avoid liability under a surety contract.

The *Dormell* judgment caused much confusion on the exact nature of a letter of credit. In *Dormell* the distinction between a letter of credit and contract of suretyship was blurred. This had important implications for the drafting of construction guarantees. Confusion existed over the nature of the terms that need to be contained in a construction guarantee to sufficiently differentiate it from a contract of suretyship in order to preclude the issuer of the construction guarantee from introducing extraneous defences to a demand for payment under what the parties intended to be a construction guarantee. Prior to the *Dormell* case, the law was clear that extraneous defences cannot be raised to avoid liability under a construction guarantee (*Loomcraft Fabrics CC v Nedbank Ltd supra*; and *Lombard Insurance Company Ltd v Landmark Holdings (Pty) Ltd supra*). According to the court in *Dormell* (par 40–42), a party that wishes to enforce a letter of credit must prove that it has complied with the terms of the letter of credit and has a “legitimate purpose” to enforce the letter of credit. The *Dormell* judgment is also correctly criticised by the court (par 25) on the basis that it relied on the doctrine of consideration which does not form part of the South African law of contract (*Durban Corporation Superannuation Fund v Campbell* 1949 (3) SA 1057 (D) 1069; *Nel v Dritec (Pty) Ltd* 1976 (3) SA 79 (D) 84; and *Etkinol v HiCor Trading Ltd* 1999 (1) SA 111 (W) 121).

On a close analysis, the findings of the court in *Coface* cannot be faulted. The clarity that this judgment brings is to be welcomed. The approach taken by the court in *Coface* subscribes to the philosophy on which many construction contracts are based. These contracts make provision for speedy alternative dispute resolution or adjudication to prevent contractual disputes from impacting upon subsequent contracts and ultimately have the effect of delaying an entire construction project. This judgment does not only clarify the position with regard to construction guarantees but shall definitely also have an impact on retention bonds. Often construction contracts call for a performance-bond/construction guarantee and a retention bond. The purpose of the retention bond is to place the beneficiary in a financial position to rectify or repair any defects in the works after completion of a building project by the contractor. This retention bond is held for a specified period after the completion of the works. The retention bond is a very important commercial and legal instrument to use as leverage on a contractor, which may already have in some instances left the site, to rectify or repair any defects in the works. These repairs may have to be done on an urgent basis which does not leave room for a prolonged contractual dispute and/or subsequent legal battle.

5 Conclusion

In conclusion, the judgment is warmly welcomed as it provides clarity on the legal position with regard to construction guarantees. The judgment follows previous decisions, except for the judgment in *Dormell*, handed down in respect of construction guarantees. The only defence a party can raise to avoid liability under a construction guarantee is obvious fraud. Liability under an unconditional construction guarantee is triggered by the occurrence of a specific event, such as default on part of the contractor, and making a

demand in accordance with the terms in the construction guarantee (Kelly-Louw 2013 25 *SA Merc LJ* 409 and 417). A construction guarantee is therefore independent from any underlying contract. Parties to a construction contract are strictly precluded from raising extraneous defences unless clear and proven fraud is involved.

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