Chapter 3

Higher Education Institutions and Construction Contracts: The Demand Guarantee as a Means of Security

Cayle Lupton[1]
Faculty of Law,
University of Johannesburg

Abstract

It is trite that education is an important tool in the mitigation of socio-economic problems and poverty in South Africa. Higher education institutions (HEIs) naturally have an important role to play in this regard. Campus buildings and other infrastructure are particularly important to the business of HEIs. They are used, *inter alia*, to provide student services (such as the delivery of lectures and facilitation of other forms of teaching) and to position the institution as a leader in the local and international communities, respectively. In the event that campus buildings and infrastructure require maintenance, upgrading, or expansion, HEIs may conclude a construction contract with a contractor. Construction contracts may be complex and are inherently risky. This gives rise to the need to ensure security of performance and various methods of such security are available for use. It is, however, the demand guarantee that may best secure the interests of the parties. A demand guarantee is a facility issued by a financial institution in terms of which it agrees to pay the beneficiary a certain sum of money upon delivery of documents

1 LLB, LLM, LLD. Senior lecturer in the Department of Procedural Law, University of Johannesburg and an admitted attorney of the High Court of South Africa.

which comply with the requirements of the guarantee. Although these instruments may be used to secure any conceivable obligation, in South Africa they are widely used in the construction industry. In this context, the demand guarantee may be used to secure the interests of the employer (for the proper performance of the contractor's obligations), or the contractor (for the performance of the employer's payment obligations). Against this background, this chapter aims to recommend to HEIs the use of demand guarantees in construction projects. The point is made in this chapter that by using demand guarantees in construction projects, HEIs will ensure their liquidity, which is essential to the fulfilment of their day-to-day operations.

1. Introduction

Campus buildings and other infrastructure are vital to the business of higher education institutions (HEIs).[2] In relation to teaching and learning, they are used, *inter alia*, in the facilitation of lectures, practical studies, and scientific experiments as well as in the implementation of tools and strategies that promote effective teaching and learning.[3] They also have a significant role to play in positioning HEIs as leaders in the local and international communities. In this regard, campus buildings house faculties and academic centres that equip students to contribute meaningfully to society and the economy,[4] as well as produce research in response to societal, economic and other challenges. HEI establishments involved in the provision of basic goods and services are also noteworthy in this context.[5]

2 The basic function of HEIs is to facilitate teaching, learning and research. See Ford "The functions of higher education" 2017 *The American Journal of Economics and Sociology* 559-561.

3 The projector, a mounted electronic device used to display teaching and learning content, is a widely used tool in this regard.

4 On the different ways in which HEIs contribute specifically to small business development, see Green and Venkatachalam "Institutions of higher education as engines of small business development" 2005 *Journal of Higher Education Outreach and Engagement* 49-67.

5 For example, most law faculties in South Africa, through law clinics, provide legal services to indigent members of the community. Law clinics are therefore important to civil society. See, for example, the case of *Stellenbosch University Law Clinic v*

In the event that campus buildings and other infrastructure require maintenance, upgrading, or expansion, HEIs may enter into construction contracts.[6] Construction contracts can be distinguished from other commercial contracts on two main grounds. The first is that they are generally more complex than other commercial contracts.[7] This can be ascribed to the many aspects – and the extent of those aspects – of construction contracts. These aspects include the duration of the project, its size, procurement and tender procedures, approval processes and structures, supervision, regulatory requirements and expectations, and the many different parties that may potentially become involved, to name but a few. By contrast, other commercial transactions are generally more straightforward. This is especially true of contracts of sale where payment and delivery of the goods do not necessarily involve a host of different factors.[8]

Construction contracts, secondly, are riskier than other commercial contracts.[9] The following risks are most prevalent in construction transactions: design errors and construction defects; natural risks (bad weather, earthquakes, floods and so on), labour risks (strikes and riots); human risks (fraud, vandalism, and disease), site risks (environmental contaminations and latent surface conditions), regulatory risks (complex regulatory approval processes), and financial risks (terrorism, war, and variations in wages and prices).[10] Bailey states that major building

---

Lifestyle Direct Group International (Pty) Ltd (16262/2019) 2021 ZAWCHC 133; [2021] 4 All SA 219 (WCC); 2022 (2) SA 237 (WCC).

6 The term "construction contract" is broad and encompasses both contracts for building works (above ground) and engineering works (below ground). See Adriaanse *Construction Contract Law* (2010) 1.

7 See Klee *International Construction Contract Law* (2018) 1; Marxen *Demand Guarantees in the Construction Industry: A Comparative Legal Study of their Use and Abuse from a South African, English and German Perspective* 2017 LLD thesis, University of Johannesburg 2.

8 See Hugo "Payment in and financing of international sale transactions" in Sharrock (ed) *The Law of Banking and Payment in South Africa* (2016) 394-433.

9 Reed *Construction All Risks Insurance* (2014) 1.

10 On these and other risks in construction, see 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* 51-52; Adriaanse (n 5) 4-5.

and engineering projects may give rise to "some of the most factually detailed and legally complicated disputes one may encounter in commercial law".[11] This statement finds support in South Africa where, over the last decade, construction contracts have received considerable attention from the judiciary.[12] In fact, there have been several judgments relating specifically to HEIs involved in construction contracts.[13] The general theme emerging from the case law is that construction disputes give rise to difficult (legal and non-legal) questions which mostly result in protracted litigation and arbitration proceedings. Such proceedings may in turn also have a bearing on the completion of the construction works.[14] Moreover, the different regulatory frameworks within which public and private entities (in this context, HEIs and contractors) operate potentially raises the complexity of the transaction and consequently the possibility of disputes between the parties. Clearly, against this background, there is a need for security of performance in construction transactions.

11 Bailey *Construction Law* (2011) 1419. See also Circo *Contract Law in the Construction Context* (2021) 5; *Radon Projects (Pty) Ltd v NV Properties (Pty) Ltd* 2013 (6) SA 345 (SCA) par 1.

12 See *Lombard Insurance Co 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); *Compass Insurance Co Ltd v Hospitality Hotel Developments (Pty) Ltd* 2012 (2) SA 537 (SCA); *First Rand Bank v Brera* 2013 (5) SA 556 (SCA); *Coface South Africa Insurance Co Ltd v East London Own Haven t/a Own Haven Housing Association* 2014 (2) SA 382 (SCA); *Kristabel Developments (Pty) Ltd v Credit Guarantee Insurance Corporation of Africa Limited* (23125/2014) 2015 ZAGPJHC 264 (20 Oct 2015); *Mutual and Federal Insurance Co Ltd v KNS Construction (Pty) Ltd* (208/2015) 2016 ZASCA 87 (31 May 2016); and *Mattress House (Pty) Ltd t/a Mia Bella Interiors v Investec Property Fund Ltd* (2017/36270) 2017 ZAGPHC 298 (13 Oct 2017).

13 See, for example, *Ekurhuleni West College v Segal* (1287/2018) 2020 ZASCA 32 (2 April 2020); *WBHO/Pro Khaya JV v The Nelson Mandela University* (2121/19) 2019 ZAECPEHC 68 (1 Oct 2019); and *University of the Western Cape v ABSA Insurance Company* (100/2015) 2015 ZAGPJHC 303 (28 Oct 2015).

14 Oftentimes construction contracts require disputes to be resolved by arbitration pending completion of the construction works. But if disputes demand earlier resolution due to their significant nature, finalisation of construction may not be a prerequisite for arbitration proceedings, thereby resulting in construction delays. See Nugent J's remarks in the *Radon Projects* case paras 3-4.

This contribution aims to recommend to HEIs the use of demand guarantees as a means of security in construction projects. To this end, it explores the operation of and law pertaining to demand guarantees in South Africa. Because English law has traditionally informed the development of the South African law relating to guarantees and commerce in general,[15] English case law and commentary are also referred to in this regard. But before exploring demand guarantees, an overview of construction transactions is provided.

2. Overview of construction transactions

The main parties to construction transactions are the employer and the contractor,[16] but subcontractors, architects, and engineers may also become involved.[17] A comprehensive discussion of the construction transaction falls beyond the scope of this contribution. Instead, a basic account of the transaction is provided with reference to the different parties involved.

Major construction contracts are invariably awarded through tender procedures. This is done to enable the employer to attract a suitable contractor that will best satisfy its construction needs and expectations. These procedures may entail an invitation to the general public or a select group of contractors and typically require a potential contractor to "sign a contract if it is awarded to it, to procure the issue of any performance or other guarantee required by the contract and not to alter or withdraw

15 Van Niekerk and Schulze *The South African Law of International Trade: Selected Topics* (2016) 248; Hugo "Protecting the lifeblood of international commerce: a critical assessment of recent judgments of the South African supreme court of appeal relating to demand guarantees" 2014 *TSAR* 661-669.

16 The employer is also referred to as the building owner, client, and principal and the contractor is also known as the building contractor, main contractor, and head contractor. The terms "contractor" and "main contractor" are used interchangeably in this contribution.

17 This is by no means a closed list. For a list containing these and other parties that may become involved in the construction project, see Mason *Innovating Construction Law* (2021) 11; Klee (n 6) 2-10. Moreover, because the parties to construction transactions and demand guarantees are mostly juristic persons, the pronoun "it" is generally used in this contribution.

his tender in the meantime".[18] As public HEIs are considered organs of state,[19] moreover, certain provisions and regulations relating to government tenders and contracts necessarily become applicable. Most noteworthy in this regard are the so-called general conditions of contract which are supplemented by special conditions of contract.[20] In the event that a contractor tenders for a construction project at a public HEI, it must comply with the requirements arising from these conditions of contract. Of particular significance is general condition 7, titled "performance security", which reads as follows:

> 7.1 Within thirty (30) days of receipt of the notification of contract award, the successful bidder shall furnish to the purchaser the performance security of the amount specified in [the special conditions of contract].
>
> 7.2 The proceeds of the performance security shall be payable to the purchaser as compensation for any loss resulting from the supplier's failure to complete his obligations under the contract.
>
> 7.3 The performance security shall be denominated in the currency of the contract, or in a freely convertible currency acceptable to the purchaser and shall be in one of the following forms:
>
> (a) a bank guarantee or an irrevocable letter of credit issued by a reputable bank located in the purchaser's country or abroad, acceptable to the purchaser, in the form provided in the bidding documents or another form acceptable to the purchaser; or
>
> (b) a cashier's or certified cheque

18 Kelly-Louw "Selective Legal Aspects of Bank Demand Guarantees" 2008 LLD thesis, UNISA 27.

19 For the definition of the term "organ of state" see s 239 of the *Constitution of the Republic of South Africa*, 1996 (hereafter "the Constitution").

20 National Treasury *Government Procurement: General Conditions of Contract* (2010). The scope of application of the general conditions are expressed in condition 2.1 as follows: "These general conditions are applicable to all bids, contracts and orders including bids for functional and professional services, sales, hiring, letting and the granting or acquiring of rights, but excluding immovable property, unless otherwise indicated in the bidding documents".

> 7.4 The performance security will be discharged by the purchaser and returned to the supplier not later than thirty (30) days following the date of completion of the supplier's performance obligations under the contract, including any warranty obligations, unless otherwise specified in [the special conditions of contract].[21]

Such performance security may indeed be a demand guarantee. It follows that only upon compliance with the general conditions of contract, and particularly the performance security condition, will the successful contractor conclude a construction contract with a public HEI.

The construction contract sets out the construction requirements and expectations.[22] Although the contract is concluded between the employer and the main contractor, in practice construction work is often rendered by a subcontractor and not the main contractor.[23] This "modern trend"[24] is ascribed to increasing specialisation in the construction industry and, possibly, the desire to shift accountability (and potential liability) relating to the construction workers themselves from the main contractor to the subcontractor.[25] Two types of subcontractors can be distinguished, namely, domestic subcontractors and nominated subcontractors. The difference between the two lies not in the contractual arrangements, since both subcontractors ultimately conclude a subcontract with the main contractor. Rather, it lies in the way in which they are appointed – nominated subcontractors are expressly indicated in the main construction

21 National Treasury (n 19) condition 7.

22 These requirements and expectations may be narrowly or broadly defined, depending on the specific needs of the employer. On the factors that may influence the scope of construction requirements and expectations, see Haidar *Handbook of Contract Management in Construction* (2021) 34.

23 Adriaanse (n 5) 242; Uff *Construction Law* (2013) 138-139.

24 Ramsden *McKenzie's Law of Building and Engineering Contracts and Arbitration* (2014) 167.

25 Bailey (n 10) 1294 ft 1 explains that "[o]ne of the potential advantages to a main contractor of subcontracting some part or all of its work is that it does not incur obligations *vis-à-vis* the subcontractor's workers that it would do if it employed those workers directly".

contract between the employer and the main contractor, while domestic subcontractors are elected entirely by the main contractor.[26]

It is important to emphasise the fact that no contractual relationship exists between the employer and the (domestic or nominated) subcontractor.[27] The implication is that a discrepancy raised by the subcontractor concerning construction design, materials, work, or even payment is to be directed to the main contractor based on the subcontract. Hence, in most cases, it is the main contractor – and not the employer – that is held liable for discrepancies raised by the subcontractor in relation to the construction work.[28] This position is consistent with the canon of privity of contract, which entails that "a contract generally creates personal rights and duties only for the parties to the contract, and for nobody else".[29]

Architects and engineers that are known as "construction professionals"[30] are typically also engaged in construction transactions. Since the employer will not have in-depth knowledge of the key aspects of the transaction, architects and engineers may be brought on board to assist the employer in this regard.[31] The scope of the services that may be rendered by construction professionals is vast. Firstly, they may assist in

26 Hughes, Champion and Murdoch *Construction Contracts: Law and Management* (2015) 307. There are many advantages for an employer that nominates a subcontractor in the construction contract. Two advantages are especially noteworthy: the first is that nominated subcontracting avoids the need to enter into tender processes in relation to the appointment of a subcontractor. This saves the employer time and money. The second is that it allows the employer control of the allocation of responsibility.

27 Uff (n 22) 318; Adriaanse (n 5) 242.

28 See, for example, *Phenix Construction Technology Ltd v Hollard Insurance Company Ltd* (10995/2015) 2017 ZAGPJHC 174 (4 May 2017).

29 Hutchison and Pretorius (eds) *The Law of Contract in South Africa* (2017) 233. In the construction context, the canon of privity of contract has received much attention from legal commentators. See Bailey (n 10) 1295-1297; Marxen (n 6) 16-19; and Adriaanse (n 5) 246, 278-292.

30 Adriaanse (n 5) 99.

31 Therefore, to regulate the relationship, the employer and construction professional will conclude a contract between themselves.

the design of the building upgrade, development, or expansion. Secondly, they may assist in the tender phase of the transaction. Adriaanse explains that "these professionals will also be involved in making applications for planning permission, preparing the tender documents [and] the selection of a tenderer [...]".[32] Finally, architects and engineers may be responsible for the supervision and inspection of the contractor's work according to the construction contract.[33] Given the nature of some of these services, construction professionals are generally perceived as agents of the employer.[34] The conflicting nature of their position in relation to the transaction (that is, acting as an impartial party regarding supervision and adjudication while being perceived as an agent of the employer) has brought into question their precise role and the extent of their potential liability in this regard.[35] It is nevertheless clear that construction professionals, and especially architects and engineers, fulfil an important function in the construction transaction.

Another aspect of the construction transaction is payment. In construction projects payment is often "staggered". Staggered payment arrangements entail that payment of the contract amount is not made in a lump sum but in intervals subject to the satisfactory completion of certain milestones in terms of the construction project. Once the contractor has completed a particular milestone, a payment certificate confirming the completion must be issued by the employer or engineer. The payment certificate essentially serves to trigger the payment obligations of the employer.[36] The construction contract,

32 See Adriaanse (n 5) 99.

33 Adriaanse (n 5) 104-105. Architects and engineers in this context may be referred to as (quality or quantity) surveyors, adjudicators, or certifiers. See Marxen (n 6) 16; Uff (n 22) 139-140.

34 Marxen (n 6) 15-16.

35 See Nisja "The engineer in international construction: agent? mediator? adjudicator?" 2004 *The International Construction Law Review* 230.

36 After receiving payment, the contractor then pays the subcontractor in terms of the subcontract. See Klee (n 6) 7-9; Bailey (n 10) 351. If the employer does not pay under the payment certificate the contractor may attempt to enforce payment based on the payment certificate or evidence indicating completion of the specific construction works. Alternatively, if an independent

moreover, may or may not provide for the retention of a portion of the monies due under payment certificates. Retention money is a form of protection against improper or defective contractual performance by the contractor.[37] Commentators generally agree, however, that retention money represents disadvantages for both the employer and the contractor.[38]

In view of this background, there is seemingly considerable scope for disputes to emerge in construction transactions. It would, therefore, be wise for the parties to be thorough in the formulation of the construction contract. A precise, clear, and accurate representation of the allocation of risk and the rights and duties of the parties is likely to reduce the occurrence of construction disputes.[39] Standard-form construction contracts may be used to achieve this objective. Such contracts are "carefully formulated by industry experts and professionals who, over many years, have paid meticulous attention to the rights and obligations of the parties to construction contracts".[40] The Joint Building Contracts Committee's suite of agreements and the General Conditions of Contract for Construction Works of the South African Institution of Civil Engineering enjoy widespread use in South Africa.[41] The standard-form contracts of the New Engineering Contract and the *Federation Internationale des Ingenieurs-Conseil* seem to be gaining ground in South Africa.[42]

---

guarantee is issued to protect the contractor, it (the contractor) may, by presenting certain stipulated documents, call up the guarantee. See the discussion in par 3 (below) on demand guarantees.

37 Bailey (n 10) 895.

38 Bailey (n 10) 896; Hugo "Construction guarantees and the Supreme Court of Appeal (2010-2013)" in Visser and Pretorius (eds) *Essays in Honour of Frans Malan* (2014) 159-164.

39 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* 448 450-451; Adriaanse (n 5) 5.

40 Lupton *Letters of credit and demand guarantees: a legal study on the impact of targeted financial sanctions from a South African perspective* 2022 LLD thesis, University of Johannesburg 38-39.

41 See Finsen *The Building Contract: A Commentary on the JBCC Agreements* (2018); South African Institution of Civil Engineering *Management Guide to the General Conditions of Contract* (2010).

42 See, for example, *Group Five Construction (Pty) Ltd v Transnet SOC Limited* (45879/2018) 2019 ZAGPJHC 328 (28 June 2019); *SA*

Even when standard-form construction contracts are utilised, however, disputes between the parties (and consequently lengthy and expensive dispute resolution proceedings) are still conceivable. And so, it is imperative to consider using security instruments in construction transactions. This is particularly the case in transactions relating to the higher education sector in which cash plays a vital role in the fulfilment of daily operations and the pursuit of HEI projects.[43] It would accordingly be prudent for HEIs involved in construction transactions to obtain security for the satisfactory performance of the contractor's obligations. Such security must be able to provide the HEI with funds almost immediately and with relative ease. It must also provide the HEI with an assurance that payment will be made upon mere demand irrespective of disputes arising from the construction contract. While several security instruments are available for use, including accessory guarantees,[44] insurance policies,[45] and indemnities,[46] it is the demand guarantee that may best secure the interests of HEIs.[47] Hence the demand guarantee is the focus of this chapter.

National Roads Agency SOC Limited v Fountain Civil Engineering (Pty) Ltd (395/2020) 2021 ZASCA 118 (20 Sep 2021).

43 This is clear from the 2021 report on the financial statistics of HEIs in South Africa as prepared by Statistics South Africa: https://www.statssa.gov.za/publications/P91031/P910312021.pdf (11-04-2023).

44 For background on accessory guarantees, see Kelly-Louw "Construing whether a guarantee is accessory or independent is key" in Hugo and Kelly-Louw (eds) *Jopie: Jurist, Mentor, Supervisor and Friend – Essays on the Law of Banking, Companies and Suretyship* (2017) 110-116. Also see, in this regard, Forsyth and Pretorius *Caney's Law of Suretyship in South Africa* (2010) 28-29.

45 For background on insurance policies, see generally Bird *Insurance Law in the United Kingdom* (2010).

46 For background on indemnities, see Bailey (n 10) 910-911.

47 For a comparative study on all these security instruments, see Marxen (n 6) 90-100; Hugo "Bank guarantees" in Sharrock (ed) *The Law of Banking and Payment in South Africa* (2016) 437, 446-449 (in relation to accessory guarantees and demand guarantees); Kelly-Louw (n 17) 91-92 (in relation to insurance policies and independent guarantees). The conclusion reached in all these commentaries is that demand guarantees are superior to the other security devices under consideration.

3. Demand guarantees

3.1 Operation

A demand or independent guarantee is a facility issued by a guarantor, normally a bank or an insurance company,[48] in terms of which the guarantor agrees to pay a stipulated sum of money to a beneficiary (for example, an HEI in a construction contract) upon the delivery of a conforming demand.[49] The party who approaches the financial institution for the issuance of the guarantee is known as the applicant (the contractor in the construction contract). The circumstances under which a call may be made on a guarantee are expressed in the guarantee itself. Common trigger events include an allegation of breach of the underlying contract on the part of the applicant and the liquidation of the applicant. A growing trend in this regard has been the requirement of a precise demand supported by additional documents such as a notice of cancellation or liquidation order.[50] Provided the demand is in conformance with the requirements of the guarantee, it serves as

48 Interestingly, the vast majority of demand-guarantee case law in South Africa involves an insurance company acting as guarantor rather than a bank. The rationale for this trend is likely to be informed by, *inter alia*, the favourable security requirements of insurance companies. See Lupton and Huneberg "Issuance of independent guarantees by insurance companies" 2023 *Journal for Juridical Science* 16-29.

49 Enonchong *The Independence Principle of Letters of Credit and Demand Guarantees* (2011) 39. Demand guarantees operate in a similar fashion to letters of credit. The main difference between the two instruments, however, is that demand guarantees provide a security function while letters of credit serve as a mode of payment. Horowitz *Letters of Credit and Demand Guarantees: Defences to Payment* (2010) 227 explains this difference as follows: "[l]etters of credit and guarantees share the characteristic of abstraction from the underlying agreement that called for their use. Nonetheless, they differ on one key aspect. Letters of credit are primary both in form and intent. They do what they appear to do: serve as the payment method for the transaction. By contrast demand guarantees are primary in form, but secondary in intent. They bear the appearance of primary instruments, because they represent an on-demand form of payment. However they are secondary in intent, inasmuch as they serve a 'back-up', or standby, role".

50 See Byrne *Standby and Demand Guarantee Practice: Understanding UCP600, ISP98 & URDG 758* (2014) 150.

"conclusive evidence that payment is due".[51] It is, therefore, clear that demand guarantees are intended to ensure swift and easy access to funds. Hence, Kelly-Louw describes these instruments as a "substitute for cash".[52]

Most countries do not have specific legislation governing demand guarantees, including South Africa. In such instances, these instruments may be regulated by internationally established sets of rules which become operative through contractual incorporation. Several international frameworks are available for incorporation. These are the Uniform Rules for Demand Guarantees (URDG 758);[53] the International Standby Practices (ISP98);[54] the United Nations Convention on Independent Guarantees and Stand-by Letters of Credit (UNCITRAL Convention);[55] and, in the case where the guarantee takes the form of a standby letter of credit,[56] the Uniform Customs and Practice for Documentary Credits (UCP 600).[57] In the event that none of these rules are contractually incorporated (and the guarantee is not regulated by legislation), the provisions of the guarantee must be interpreted in accordance with the law of contract of the country concerned.[58] None of these sets of rules enjoy strong usage in South Africa.

The operation of the demand guarantee in the context of this contribution may be explained by way of example. Suppose an HEI wishes to develop and upgrade all its campus buildings.

51 *State Bank of India v Denel SOC Limited* [2015] 2 All SA 152 (SCA) par 9.

52 Kelly-Louw "The documentary nature of demand guarantees and the doctrine of strict compliance (part 1)" 2009 *SA Merc LJ* 306-307.

53 International Chamber of Commerce "Uniform Rules for Demand Guarantees 758" 2010.

54 International Chamber of Commerce "International Standby Practices 590" 1998.

55 Since its effective date of January 2000, very few countries have acceded to this Convention, including South Africa.

56 From an operational and legal perspective, the standby letter of credit mirrors the independent guarantee. They diverge, however, with regard to the contexts in which they are typically used. See Kelly-Louw (n 17) 1.

57 International Chamber of Commerce "Uniform Customs and Practice for Documentary Credits 600" 2007.

58 *Minister of Transport and Public Works, Western Cape v Zanbuild Construction (Pty) Ltd* 2011 (5) SA 528 (SCA) par 19.

Following the finalisation of the tendering process, it concludes a construction contract (the underlying contract) with the successful contractor (Party A). In accordance with the underlying contract, Party A is required to provide security for the proper performance of its obligations by procuring the issuance of a demand guarantee in favour of the HEI. Party A approaches its bank (Party B) to provide a guarantee in favour of the HEI.[59] After establishing Party A's creditworthiness,[60] Party B issues the guarantee. The guarantee provides the following: "The HEI will be paid upon presentation of a written demand alleging cancellation of the contract due to defective performance or non-performance by Party A". In the course of the construction, the HEI identifies several deficiencies in the performance by Party A. The HEI consequently cancels the underlying contract and calls up the guarantee. Party B must make payment if the demand by the HEI meets the requirements of the guarantee.

In this example Party B is the guarantor, the HEI the beneficiary, and Party A the applicant. The contract between the applicant and the guarantor is one of mandate. The contract of guarantee between Party B and the HEI is autonomous of the underlying contract and the mandate. This independence is a strong rule of demand-guarantee law and is discussed in more detail below. Once the guarantor has received the demand it must examine the demand to establish whether it is in conformance with the requirements of the guarantee. If it is a compliant demand, the guarantor is liable to pay the beneficiary, after which reimbursement may be sought from the applicant.[61]

Several different kinds of demand guarantees are common in the construction sector, such as payment guarantees, performance guarantees, advance payment guarantees, and retention, maintenance and tender guarantees.[62] The question

59 Enonchong (n 48) 43 states that "[t]he 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".

60 Bertrams *Bank Guarantees in International Trade* (2013) 22.

61 Enonchong (n 48) 294.

62 A comprehensive discussion of the different types of demand guarantees is not provided in this contribution. See Bertrams (n 59)

as to which guarantee should be sought is dependent on the specific risk that requires mitigation. For example, if an HEI (as the employer in the construction contract) wishes to cover itself against the financial risks relating to defective performance by or insolvency on the part of the contractor, a performance guarantee may be most appropriate. Indeed, the example provided above relating to the operation of the demand guarantee involves a performance guarantee. Or, where the HEI agrees to make an advance payment of the contract value to the contractor to enable preliminary work on the project, it may be wise for the HEI to require of the contractor to present a guarantee securing the contractor's repayment obligations. Such a guarantee is known as an advance payment guarantee.[63] One last example will suffice. To avoid the negative effect retention monies may have on the cash flow of the contractor,[64] the HEI may require that a retention guarantee be issued in its favour instead. Practically, this means that the HEI will be entitled to call up the guarantee should a defect emerge later in the execution of the works.

Although the different types of demand guarantees may be used to secure different risks in the construction project, they are all based on the same legal principles. These legal principles are examined in the section below.

3.2 Legal principles

Demand guarantees, encountered mostly in the construction context, have received much attention from the South African courts during the past decade.[65] The case law in point generally contributes to the development and a better understanding

36-43.

63 An "advance payment guarantee" should not be confused with a "payment guarantee". The latter may be used to secure the payment undertaking of the employer towards the contractor. Hence the beneficiary of such a guarantee is usually the contractor. See Lupton "Demand guarantees in the construction industry: recent developments in the law relating to the fraud exception to the independence principle" 2019 *SA Merc LJ* 399-404, with reference to the *Phenix* case.

64 Marxen (n 6) 84.

65 Hugo (n 46) 437.

of the law relating to demand guarantees.[66] More specifically, attention is often directed to the two fundamental legal principles of demand guarantees, namely, the principle of documentary compliance and the independence principle.

The first legal principle entails that the guarantor is obliged to pay where the documentary submission complies with the requirements of the guarantee. But if the documents are non-conforming, the guarantor may refuse to pay. The case law to this principle is, however, riddled with confusion and inconsistency. In particular, the question of what the acceptable standard of compliance is in this regard is unclear. Two opposing standards emerge from case law, namely, strict compliance and substantial compliance. The former requires exact compliance with the wording of the requirements of the guarantee.[67] The latter requires material conformity with the requirements of the guarantee.[68] Thus, pursuant to this latter standard, obvious errors such as spelling mistakes are not over-emphasised and do not by themselves render a demand non-conforming. While the courts have had ample opportunity to provide clarity on this issue, they have mostly shied away from making clear pronouncements in this regard.

In his recent doctoral thesis focused on the conformity of demands, Chivizhe submits that, in view of the conflicting baggage that terms such as "strict compliance" and "substantial compliance" carry, placing too much emphasis on determining the applicable standard "has no practical use".[69] He offers the following suggestion:

66 Lupton "'On demand payment' character of independent guarantees" 2022 *TSAR* 569-570.

67 See the *Compass Insurance* case; the *Denel* case; and *Nedbank Ltd v Procprops 60 (Pty) Ltd* (108/2013) 2013 ZASCA 153 (20 Nov 2013). See further Kelly-Louw "An interpretation of a 'compliant demand' for a demand guarantee gone wrong" 2023 *THRHR* 261-273.

68 See *Lombard Insurance Co Ltd v Schoeman* 2018 (1) SA 240 (GJ)); *Schoeman v Lombard Insurance Co Ltd* (1299/2017) 2019 ZASCA 66 (29 May 2019), with reference to the phrase "sufficient compliance".

69 Chivizhe *A Comparative Study of the Law and Practice Relating to the Compliance of Documents Calling for Payment under Letters of Credit and Demand Guarantees* 2021 thesis, North-West University 291.

> The proper approach is to acknowledge the importance of both letters of credit and guarantees as lifeblood of commerce, and to recognise that for both of them to retain their strong security reputation, a high level of conformity is required. On the other hand, too strict a standard, with a concomitant high number of rejections of demands and documents, is likely to stifle their use and usefulness. In determining the level of conformity required, the purpose of the instrument concerned must also be considered as part of a *purposive approach*.[70]

This suggestion, it is submitted, has much merit because a purposive approach is likely to promote the usefulness of these instruments as well as ensure legal certainty and predictability of outcome.

The second legal principle, the independence principle, entails that the liability of the guarantor as against the beneficiary must be ascertained with reference to the provisions of the instrument, and not also the provisions of the underlying contract or any other related contract. This means that if conforming documents are tendered, the guarantor must effect payment regardless of any disputes arising from any of the contracts other than the guarantee. Article 5(a) of the URDG 758 puts it thus:

> 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.

Demand guarantees are nevertheless susceptible to abuse. As such, justice and fairness militate against the notion that the independence principle is absolute. In other words, in certain

70 Chivizhe (n 69) 291.

instances a claim on the guarantee can be defended by the guarantor or applicant on the basis of a dispute arising from the underlying contract. In the common-law jurisdictions the legal basis for these "instances", or "exceptions" to the independence principle as they are often referred to, is public policy.[71]

Currently, fraud by the beneficiary is the only firmly established exception in South African law. In the demand-guarantee context, fraud emerging from the documents (typically forgery and falsification) and from the beneficiary's behaviour as it relates to the underlying contract is relevant.[72] Practically, the latter means that where the beneficiary dishonestly presents a claim under a guarantee knowing that it is not entitled to payment, the guarantor or applicant may raise the beneficiary's dishonest behaviour as a defence to payment. In *Guardrisk Insurance Company Ltd v Kentz (Pty) Ltd*, the supreme court of appeal held:[73]

> [i]t 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]

In English law the fraud exception is similarly formulated with reference to the beneficiary having "no honest belief" in the legitimacy of the demand.[75] Thus, knowledge of the beneficiary to its disentitlement has developed as an integral element of the fraud exception in both South African and English law.

Against this background, two recent developments in South African law – both of which arose in the construction context –

71 Hugo (n 46) 450. See also the letter of credit case of *Sztejn v J Henry Schroder Banking Corp* 31 NYS 2d 1941.

72 The fraud exception as it applies to letters of credit, however, is restricted to forgery and falsification of the documents. See Hugo "Demand guarantees in the People's Republic of China and the Republic of South Africa" 2019 *BRICS LJ* 4 15.

73 *Guardrisk Insurance Company Ltd v Kentz (Pty) Ltd* [2014] 1 All SA 307 (SCA).

74 par 17 of the *Guardrisk* case (the author's emphasis).

75 *National Infrastructure Development Co Ltd v Banco Santander SA* 2016 EWHC 2990 (Comm) par 11.

merit consideration. The first concerns the question of whether an arbitration award based on a dispute emanating from the underlying contract or a final payment certificate reflecting a nil balance owed for works in terms of the underlying contract, may constitute a valid defence to payment. The question first arose in the *Dormell* case in 2011 where Bertelsmann AJ, writing for the majority, concluded that an arbitration award against the beneficiary meant that the beneficiary "lost the right to enforce the guarantee".[76] Therefore, the court recognised a further defence to payment: namely, an arbitral award. The period after the *Dormell* case saw an increase in cases where banks raised contractual disputes to escape liability under guarantees. This continued until 2014 when the Supreme Court of Appeal in the *Coface* case held that "the decision of the majority in *Dormell* was clearly wrong",[77] and found that a defence based on a payment certificate issued in terms of the underlying contract (and, by implication, a defence based on an arbitral award relating to the underlying contract) violates the independence principle and therefore is unacceptable.[78] While the approach in the *Coface* case is sensible in instances where the call on the guarantee precedes the arbitral award or issuing of the payment certificate (as was the position in the above cases), it is doubtful whether it should also be applied in instances where the call on the guarantee occurs after the award or certificate is issued. This is because in such instances the arbitral award or payment certificate may serve as evidence indicating that the demand is in fact a dishonest one. Put differently, it was made by the beneficiary in the knowledge of the disentitlement to payment.[79]

Secondly, the question has arisen of whether the beneficiary's grossly disproportionate demand must be considered with reference to the principles of the fraud exception. In the *Phenix* case, the court was concerned with a situation where the beneficiary's demand was for the full amount guaranteed, yet it knew that it was entitled only to a portion of the guaranteed

76 the *Dormell* case par 41.
77 the *Coface* case par 25.
78 the *Coface* case paras 9-26.
79 Hugo (n 14) 666.

amount.[80] The court held that because the beneficiary had knowledge of its disentitlement to the full amount, its demand was fraudulent.[81]

Proving fraud, however, is no easy task, since courts do not lightly infer fraud. In *Raubex Construction (Pty) Ltd v Bryte Insurance Company Limited*,[82] the Supreme Court of Appeal put it as follows:

> Fraud will not be readily inferred; particularly where it is sought to be established in motion proceedings. A mere error, misunderstanding or oversight, however unreasonable, does not amount to fraud and it is insufficient to show that contentions are incorrect. A party has to go further and show that the representor advanced the contentions in bad faith, knowing them to be incorrect.[83]

Hence a defence based on fraud has rarely succeeded in South Africa.[84] To date, no other defence to payment has been raised successfully in the South African courts.[85] Commentators nevertheless agree that notions of justice and fairness require the recognition of an illegality exception.[86] In the construction

80 the *Phenix* case par 21.
81 the *Phenix* case par 53. See the case discussion in Lupton (n 63) 404-408.
82 the *Raubex* case [2019] 2 All SA (SCA).
83 the *Raubex* case par 24. See further *Loomcraft Fabrics CC v Landmark Holdings (Pty) Ltd* 1996 (1) SA 812 (A) 817G; *RD Harbottle (Mercantile) Ltd v National Westminster Bank Ltd* [1977] 2 All ER 862 (QB) 870b-d.
84 To the author's knowledge, a defence based on fraud has succeeded in only two South African cases: namely, the *Phenix* case and *Group Five Construction (Pty) Ltd v MEC for Public Transport, Roads and Works Gauteng* (2009/31971) 2015 ZAGPJHC 55 (13 Feb 2015).
85 See, for example, the contentions raised regarding prescription in *Investec Bank Ltd v Lombard Insurance Co Ltd* (69330/2018) 2019 ZAGPPHC 251 (26 June 2019); bad faith in the *Bryte* case; and the issue of breach of negative stipulations in the underlying contract in *Joint Venture between Aveng (Africa) (Pty) Ltd and Strabag International GmbH v South African National Roads Agency SOC Ltd* 2021 (2) SA 137 (SCA).
86 See Lupton and Kelly-Louw "Emergence of illegality in the underlying contract as an exception to the independence principle of demand guarantees" 2020 *Comparative and International Law Journal of Southern Africa* 1 29-31, with reference to the *Mattress House* case. See also Van Niekerk and Schulze (n 14) 291. An illegality defence has emerged in English law. See in this regard

context, an illegality defence could conceivably be invoked in the event of non-compliance with applicable building codes or zoning laws, an unlawfully awarded tender or a failure to obtain the necessary licences for engineering projects, to name a few.[87] The question as to the requirements and parameters of a potential illegality defence needs to be determined by the courts.[88]

4. Conclusion

Campus buildings and other infrastructure are important to the business of HEIs. In the event that they require maintenance, upgrading, or expansion, HEIs may enter into construction contracts with contractors. Construction contracts may be complex and inherently risky. This gives rise to the need to ensure the security of performance. In this contribution, an argument was made in favour of the use of demand guarantees in construction projects. More specifically, it was contended that it is in the best interests of HEIs to require that a demand guarantee be issued in its favour to secure the proper performance of the contractor's obligations.

From the discussion above, demand guarantees ensure easy and swift access to funds. This is attributed, in the first place, to the principle of documentary compliance. The mere presentation of conforming documents entitles the beneficiary to payment. Conventional demand-guarantee practice accordingly does not require an investigation beyond the documents, which may otherwise result in payment delays. The independence principle, secondly, ensures that disputes arising from the underlying construction contract do not affect the guarantor's payment obligations. Thus, an HEI, as beneficiary of a guarantee, can expect payment soon after it tenders conforming documents,

Group Josi Re v Walbrook Insurance Co Ltd & Others 1996 1 Lloyd's Rep 345 (CA); *Mahonia Ltd v JP Morgan Chase Bank* 2003 2 *Lloyd's Rep* 911 (QB); and *Mahonia Ltd v JP Morgan Chase Bank* 2004 EWHC 1938.

87 See Marxen (n 6) 156-157.

88 Lupton and Kelly-Louw (n 85) 31 nevertheless recommend a set of minimum requirements for an illegality defence to succeed: namely, that the alleged illegality must (i) be clearly established, (ii) be sufficiently serious, and (iii) directly affect or taint the guarantee.

regardless of any objections raised by the contractor relating to the construction work. Moreover, even if the guarantor or the contractor, as applicant of the guarantee, raises fraud as a defence to the HEI's demand, a clear and convincing case will need to be established for it to succeed with this defence. The demand guarantee therefore is an effective and reliable means of security available to HEIs involved in construction transactions. The author concludes by stating that by using demand guarantees in construction projects, HEIs will ensure their liquidity, which is essential to the fulfilment of their day-to-day operations.