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DISPUTE RESOLUTION ALERT

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ISSUE

CONSTRUCTION AND ENGINEERING:
A STRONG CAVEAT REGARDING SO-CALLED
"ON-DEMAND" PERFORMANCE GUARANTEES

CONSTRUCTION AND ENGINEERING: A STRONG CAVEAT REGARDING SO-CALLED “ON-DEMAND” PERFORMANCE GUARANTEES

KNS launched an application demanding payment of the guarantee on the basis that, as the guarantee was a ‘call’ or ‘on-demand’ guarantee, it had become payable. Aqua argued that the guarantee was a conditional guarantee inextricably linked to the subcontract - since it was not in breach of the subcontract, the guarantee was neither due nor payable.

Twala AJ agreed with the arguments raised by KNS that the guarantee was a call or on-demand guarantee, holding that the wording of the guarantee created an obligation on the part of M&F to pay KNS...when a written demand was made by KNS.



In the case of *Mutual & Federal v KNS Construction (208/15) [2016] ZASCA 87 (31 May 2016)*, KNS Construction (Pty) Ltd (KNS) was awarded a contract by the South African National Roads Agency Limited (SANRAL) for the construction of road works in KwaZulu Natal. Thereafter, KNS entered into a subcontract with Aqua Transport & Plant Hire (Pty) Limited (Aqua) which subcontract required Aqua to provide a performance guarantee in respect of its obligations. Mutual and Federal Insurance Company Limited (M&F), accordingly, issued the guarantee on behalf of Aqua in favour of KNS. SANRAL subsequently terminated the main contract with KNS.

KNS thereafter terminated the subcontract with Aqua and threatened to call up the guarantee on the basis of Aqua’s failure to commence, proceed with or complete the project, should Aqua not rectify its performance within 14 days. The performance bond was subsequently called on by KNS.

The High Court:

KNS launched an application demanding payment of the guarantee on the basis that, as the guarantee was a ‘call’ or ‘on-demand’ guarantee, it had become payable. Aqua argued that the guarantee was a conditional guarantee inextricably linked to the subcontract - since it was not in breach of the subcontract, the guarantee was neither due nor payable. Twala AJ agreed with the arguments raised by KNS that the guarantee was a call or on-demand guarantee, holding that the wording of the guarantee created an obligation on the part of M&F to pay KNS, among other things, when a written demand was made by KNS.

Supreme Court of Appeal:

On appeal, M&F reiterated that the guarantee is a conditional guarantee, inextricably linked to the underlying contract (akin to suretyship) and not an on-demand guarantee.

The Supreme Court of Appeal (SCA) considered the provisions of the following judgments:

- In *Novartis SA v Maphil Trading* 2016 (1) SA 518 (SCA) where the court held that “the interpretative process is one of ascertaining the intention of the parties ... [T]he court must consider all the circumstances surrounding the contract to determine what their intention was in concluding it...and the court should always consider the factual matrix in which the contract is concluded – the context to determine the parties’ intention”. It is evident that the SCA in *Novartis SA* tended away from a strict literal interpretation of the wording of the contract.



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The guarantee was held to be inextricably linked to the sub-contract and therefore akin to a suretyship and not due and payable.



- In *Lombard Insurance Co Ltd v Landmark Holdings (Pty) Ltd & Others* 2010 (2) SA 86 (SCA), the court was faced with the interpretation of a guarantee containing a clause expressly recording that any reference made in the guarantee to the principal agreement was solely for "purpose of convenience and shall not be construed as any intention whatsoever to create an accessory obligation or ... a suretyship". The court held that the guarantee creates an obligation to pay upon the happening of an event, and whatever disputes may subsequently arise between the buyer and seller are of no moment insofar as the bank's obligation is concerned.
- In *Minister of Transport and Public Works, Western Cape, & Another v Zanbuild Construction (Pty) Ltd & Another* 2011 (5) SA 528 (SCA), the court interpreted a performance guarantee and, unlike in *Lombard*, the court in *Zanbuild* held that the guarantee gave rise to liability akin to suretyship on the basis that it was to provide "security for the compliance of the contractor's performance of obligations in accordance with the contract" and that the bank guarantees "the due and faithful performance by the contractor".

In the KNS judgment, the guarantee states that it is issued for the 'due fulfilment' by Aqua of its obligations to KNS in terms of the sub-contract. Furthermore, that the guarantee amount is payable "on

receipt of a written demand from KNS [Construction], which demand may be made by KNS [Construction] if (in your opinion and at your sole discretion) the said Contractor [Aqua] fails and/or neglects to proceed therewith or if, for any reason he fails and/or neglects to complete the services in accordance with the conditions of contract".

The court stated that the true purpose was to guarantee the due performance by Aqua. The guarantee was only payable if Aqua breached the subcontract as expressly stated in the guarantee. Accordingly, the guarantee was held to be inextricably linked to the sub-contract and therefore akin to a suretyship and not due and payable.

Importance of the judgment:

Given the above, it is our view that when an on-demand guarantee is issued in your favour, the following conditions, among other conditions, are expressly included:

1. Any reference to the principal agreement is solely for sake of convenience and should not be construed as an intention to create an accessory obligation or suretyship.
2. Any disputes which may arise between the parties is of no consequence to the guarantor honouring its obligations under the guarantee.
3. The guarantor undertakes to make payment upon the conditions contained only in the guarantee being met.

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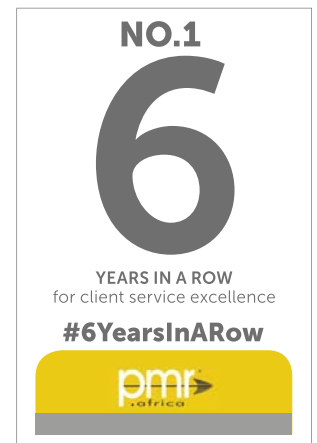
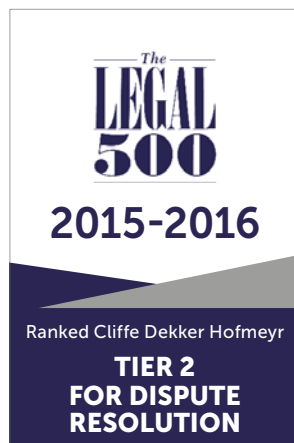
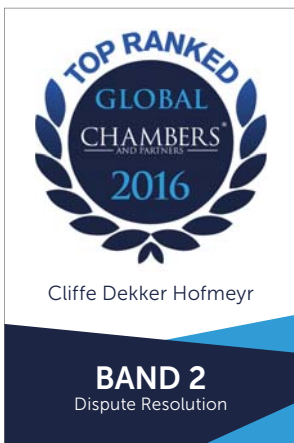
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It is therefore vital to obtain comprehensive legal advice prior to entering into a guarantee or suretyship agreement; the consequence of these two legal constructs differ substantially.

Absent the above conditions, and should a dispute arise between the parties in regard to whether the guarantee is an on demand or conditional guarantee, a court may find that the guarantee entered into between the parties is akin to suretyship and thus reliant on a valid and enforceable underlying agreement. It is therefore vital to obtain comprehensive legal advice prior

to entering into a guarantee or suretyship agreement; the consequence of these two legal constructs differ substantially and it is therefore critical that the parties are made aware of the exact mechanics of the agreement they are entering into.

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