

Banking, Finance & Projects

ALERT | 5 September 2024



In this issue

SOUTH AFRICA

A cautionary tale on demand guarantees



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A cautionary tale on demand guarantees

Guarantees from related parties of a borrower have become standard for most financing transactions. This is partly due to the advantage that guarantees have in comparison to security, when considering the prospects of the recovery of a funder's investment.

The advantage of a guarantee lies in its nature – it is established in our law that guarantees constitute independent primary obligations from which a demand can be made regardless of the validity and/or enforceability of any related or underlying agreements, with the exception of fraud. The legality, validity and enforceability of security documents on the other hand is, as a result of their accessory nature, contingent on the legality, validity and enforceability of the underlying obligation which they secure. In most funding transactions, the conclusion of both the related party guarantee and the security documents will form part of the conditions precedent to the underlying funding agreement. The matter of *ABSA Bank Limited v Rosenberg and Another* (1255/2022) [2024] ZASCA 58 (24 April 2024) is a cautionary tale on how drafting can affect the enforceability of demand guarantees.

Facts

In 2013 Uwoyela Environmental Services Proprietary Limited (UES) was awarded a tender by the Strategic Fuel Fund (SFF) to recover and reprocess oil sludge from an underground facility (Ogies Project). UES was required, for its own account, to recover the oil sludge, process the product, and sell it as either fuel oil, crude oil and/or sludge residue to its offtakers. UES approached Absa Bank (the bank) for overdraft facilities to finance the Ogies Project. In August 2018, the bank and UES concluded a facilities letter in terms of which the bank made available to UES, a primary lending facility of US\$2,5 million and a commercial asset finance facility of R199,000. The facilities were subject to the conclusion of a cession of debtors by UES, a limited guarantee from Enviroshore Project Financing Limited (Mauritius) and a subordination of debt by Enviroshore Project Financing Limited (Mauritius), all of which were concluded.

The Ogies Project commenced in 2014 and was put on hold in 2019 due to operational health and safety concerns and cash flow challenges faced by UES. In March 2019, UES approached the bank for additional funding to finance an escrow account required by SFF in the amount of US\$14,653,500, and operational finance in the amount of US\$8,5 million. After concluding its due diligence investigation on the Ogies Project, the bank was willing to provide additional funding of no more than US\$18,5 million for both the escrow amount and the general corporate purposes, and this additional funding would be provided by way of an increase to the existing facility. The increase

BANKING, FINANCE & PROJECTS
ALERTA cautionary
tale on demand
guarantees

CONTINUED



was subject to certain conditions precedent, including, the provision of a guarantee by the respondents to the bank. The key provisions of the guarantee provided that it was effective from its signature date (being the date on which the last party signed), and that the guarantors, on a joint and severable basis, and as a principal and primary obligation, guaranteed the due, proper and punctual performance by UES (as borrower) of the secured obligations. The definition of secured obligations in the guarantee cross referenced the facilities letter, and the definition of the facilities letter in turn included the increase of the existing funding by the additional funding of US\$18,5 million with effect from the signature date.

The respondents signed the guarantee prepared by the bank on 07 August 2019 in the course of endeavours to conclude the facility conditions precedent process. Subsequent to the signature of the guarantee by the respondents, the bank declined to increase the facility by the additional US\$18,5 million because it had become apparent that not all the conditions precedent in respect of the facility would be satisfied. In addition, the bank had become concerned about UES' ability to service its debt. Notwithstanding declining to increase the facility, the bank counter-signed the guarantee on 19 March 2020, more than seven months after the respondents signed it. In accordance with the terms of the guarantee, 19 March 2020 was therefore the signature date of the guarantee as defined therein, and it was also the date on which the existing facility would be increased by the additional US\$18,5 million.

On 22 July 2020, the bank sent UES the first amendment of the facilities letter, which amended the first facilities letter concluded in 2018. The amendment to the facilities letter was countersigned by UES on 10 September 2020, and it recorded the conversion of the existing US\$2,5 million facility to a Rand denominated overdraft facility in the amount of R43,664,000. The amendment to the facilities letter also amended its security clause to include the guarantee agreement signed by the respondents on 07 August 2019. On 04 May 2021, the bank issued a written demand and notice of cancellation of the facilities letter. UES' failure to repay the amount due led to an application for its provisional winding up. Thereafter, the bank sought to receive payment of the outstanding amounts from the respondents on the basis of the guarantee and the respondents denied liability.

The bank approached the High Court with an application to enforce performance of the guarantee. The High Court dismissed the bank's application. It appears that the dismissal was on the basis that the operation of the guarantee was contingent on the provision by the bank of additional funding to UES. The Supreme Court of Appeal (SCA) matter was an appeal by the bank against the dismissal of the matter by the High Court.



A cautionary tale on demand guarantees

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The respondents argued, among other things, that their conclusion of the guarantee was predicated on the expectation that there would be an increase in the facility made available to UES by the bank. Moreover, that the bank refused to perform the reciprocal obligation in consideration of which the guarantor's obligations had been undertaken. In consequence of the failure by the bank to increase the facility, the whole agreement was ineffective, and the bank was disqualified from enforcing the agreement on the grounds of *exceptio non adimpleti contractus*. On the other hand, the bank argued that the language of the guarantee was clear and that the guarantee extended to all of UES' indebtedness to the bank, whether past, present or future. In addition, the bank argued that the respondent's contention was unsustainable as it was in contrast with the clear language of the guarantee and with the purpose and background underpinning the preparation of the document.

In the SCA, the court highlighted the following key principles.

First, the interpretation of contracts is approached holistically and must take into account the facts and context of the agreement, such that the resultant interpretation makes commercial sense. Central to the dispute between the parties was the question of the proper interpretation of the guarantee. The court found that the principles to be applied interpreting written documents are well established in both local and foreign case law. Briefly, the interpretation of documents is an objective process that includes giving consideration to (i) language used in light of the ordinary rules of grammar and syntax, (ii) the

context in which the provision appears, (iii) the apparent purpose to which it is directed, and (iv) the material known to those responsible for its production, in order to arrive at a commercially sensible meaning. The court further found that given the lack of clarity in the language of the guarantee, the context and circumstances which led to the production of the document were particularly important. The factual context of the guarantee indicated that the guarantee was concluded with the anticipation that additional funding would in turn be made available to UES. This was illustrated by the description of the guarantee as a condition precedent to the provision of the additional funding and by the reference to the additional funding in the definition of secured obligations set out in the guarantee.

Second, where a party seeks to enforce performance of an obligation in terms of a contract which is conditional on performance by such party of reciprocal obligations, the performance by that party of its reciprocal obligations is a pre-requisite



BANKING, FINANCE & PROJECTS
ALERTA cautionary
tale on demand
guarantees

CONTINUED

of their right to sue. Without such performance, the counterparty to whom the reciprocal obligation is owed may raise the defence of *exceptio non adimpleti contractus*. Failure by one party to perform its obligations absolves the other party of their obligation to perform in terms of the contract. In this regard, the court found that the reference to the additional funding on the signature date in the definition of the secured obligations imported an obligation on the bank to provide the additional funding on the signature date. As such, without first performing its own obligations under the guarantee, the bank could not seek to enforce the guarantee against the guarantors.

Key takeaways

The context of the guarantee matters and must be taken into account together with other factors to produce an interpretation of the document which makes commercial sense. The reasons why a guarantee is concluded cannot be removed from the process of the interpretation of its terms.

Careful drafting of guarantees plays a role in their enforceability as the language used in definitions can inadvertently create an obligation of reciprocity on the part of the beneficiary. In that event, the beneficiary will only be able to enforce the guarantee once it has performed its reciprocal obligation.

Kuda Chimedza and Sophie Muzamhindo

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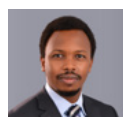
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Our BBBEE verification is one of several components of our transformation strategy and we continue to seek ways of improving it in a meaningful manner.

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