

Construction & Engineering and Dispute Resolution

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SOUTH AFRICA

Unconscionability as a defence
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Unconscionability as a defence to on-demand guarantees

On-demand performance guarantees are a staple in construction and engineering projects due to their commercial function of 'as good as cash' security, providing employers with prompt and reliable security if contractors fail to meet their obligations. Demand guarantees are designed to be autonomous instruments. The guarantor's obligation to pay arises upon presentation of a demand that complies with the guarantee's terms, regardless of disputes under the underlying contract (the independence principle). The independence principle is the main charm of demand guarantees, as the South African courts have consistently upheld the independence of these guarantees, with fraud by the beneficiary being the only recognised exception to payment.

Recently, however, the applicants in the case of *Imvula Roads and Civils (Pty) Ltd and Others v Holland Insurance Co. Ltd and Another* (2024-104602) [2025] ZAGPJHC 12 (14 January 2025), attempted to raise unconscionable conduct as a defence to avoid liability under such guarantees (the unconscionability exception) in the alternative to the fraud exception.

Background

The dispute arose from two large-scale road rehabilitation contracts where the employer required the contractors to provide on-demand performance guarantees as security for the contractors' obligations. When the employer sought to call on the guarantees following contract terminations, the contractors applied for an urgent interdict to prevent payment, arguing that the guarantees were conditional and that the demands were fraudulent, alternatively, unconscionable.

The High Court's findings

A central issue was whether the guarantees were "on-demand", i.e. payable upon demand, independent of the underlying contract or "conditional", i.e. requiring proof of default or liability under the contract. On this point, the court found that in terms of clause 5.1 of the guarantees, the guarantor's obligation to pay arose upon receipt of a compliant demand, without the need to prove the contractor's default or the validity of the contract termination. All the second respondent needed to do in terms of clause 5.1 of the guarantee was to issue the written demand and state that the contract was terminated due to the first applicant's default. There was no need to prove the validity of the contract or the validity of the cancellation thereof. As such, the guarantee in question was an on-demand performance guarantee.

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The judgment reaffirmed the independence principle; that the guarantor's obligation under an on-demand guarantee is independent of disputes under the underlying contract. The only recognised exception is fraud, where the beneficiary knowingly presents false documents or misrepresents material facts to the guarantor for example. The court emphasised that fraud must be clearly proven and is not lightly inferred; mere errors, misunderstandings, or even invalid contract terminations do not amount to fraud. In this case, it suffices to say that the applicants failed to prove any fraudulent conduct on the part of the employer. The court found that, at most, the employer may have made a mistake in terminating the contracts, but this did not meet the threshold for fraud.

Unconscionability and development of the common law

The applicants argued that even if fraud could not be established, the common law should be developed to include an unconscionability exception.

In describing unconscionability, the court relied on academic literature which described unconscionability as "taking advantage of a special disadvantage of another" or "unconscientious reliance on strict legal rights" or "action showing no regard for conscience, or that are irreconcilable with what is right or reasonable".

In this case, the applicants contended that the second respondent acted unconscionably by knowingly presenting invalid demands based on terminations they knew were not valid.

The court rejected the need to develop the common law to include the unconscionability exception on the basis that the Constitutional Court in *Beadica 231 CC and Others v Trustees for the time being of the Oregon* [2020] (5) SA 247 (CC) already stated that any contract that is contrary to the public interest will not be enforced by the courts. Here, the court suggested that the common law does not need to be extended to include unconscionable conduct as the courts will decline to enforce any contract that is contrary to public interest.

Importantly, the court also held that the issue of unconscionability "could only notionally arise if the guarantees are not on-demand guarantees and if the validity of the cancellation of the underlying construction contracts was relevant" and that "whether the second respondent mistakenly thought they were valid or not, and whether they were negligent or reckless in their thinking, and whether or not this was unconscionable, is all equally irrelevant". This suggests that where on-demand guarantees are concerned, it doesn't matter whether the employer acted unfairly (unconscionably) or not as the conduct or state of mind of the employer is not relevant to whether the guarantees must be paid, because with on-demand guarantees, the obligation to pay exists regardless of those considerations.

It is important to note that the Supreme Court of Appeal (SCA) has also dealt with this issue in the recent case of *Set Square Developments (Pty) Ltd v Power Guarantees (Pty) Ltd and Another* [2025] ZASCA 64, where the first respondent attempted to resist claims under on-demand guarantees on the basis that it was precluded by public policy to effect the payment under the guarantees and further that any finding that "the contracts were separate and autonomous would render the enforcement of the guarantees unconscionable".

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The SCA refused to entertain this defence as it was not raised on the first respondent's pleaded case, nor were facts specifically advanced thereof. Further, and more importantly for this discussion, the SCA found no authority in which the unconscionability exception was previously recognised as a basis for escaping liability under on-demand guarantees. The court reaffirmed the independence principle and held that:

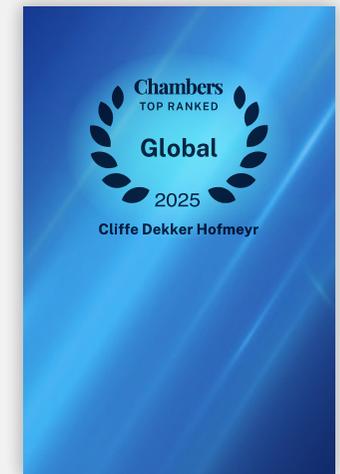
"[I]n a long line of cases, our courts have consistently applied the immutable principle that a guarantor on being presented with a valid demand in respect of an on-demand guarantee, is obliged to pay the beneficiary without interrogation of the contractual disputes between the beneficiary and the contractor."

Implications for construction industry stakeholders

This judgment underscores the importance of understanding the nature of on-demand guarantees and deciding on whether or not to use on-demand guaranteed on a project:

- **Contractors** should be aware that on-demand guarantees are likely to be enforced strictly according to their terms, regardless of disputes over the contract performance or termination.
- **Employers** can rely on the certainty provided by on-demand guarantees, but should exercise caution to avoid conduct that could be construed as fraudulent.
- **Insurers and guarantors** are generally obliged to pay upon compliant demand, unless clear evidence of fraud is presented.

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BBBEE STATUS: LEVEL ONE CONTRIBUTOR

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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