SUPREME COURT OF APPEAL OF SOUTH AFRICA

JUDGMENT

CASE NO: 050/2013

Reportable

In the matter between:

COFACE SOUTH AFRICA INSURANCE CO LTD **APPELLANT**

and

EAST LONDON OWN HAVEN t/a OWN HAVEN HOUSING ASSOCIATION **RESPONDENT**

Neutral citation: *Coface South Africa Insurance Co Ltd v East London Own Haven t/a Own Haven Housing Association* (050/13) [2013] ZASCA 202 (02 December 2013).

Coram: Navsa ADP, Maya, Malan, Pillay JJA et Swain AJA

Heard: **19 November 2013**

Delivered: **02 December 2013**

Summary: **Construction guarantee – liability absolute and unconditional – disputes in relation to the construction agreement precluded – majority decision in *Dormell Properties v Renasa Insurance NNO* 2011 (1) SA 70 (SCA) held to be clearly wrong – appeal dismissed.**

ORDER

On appeal from: South Gauteng High Court, Johannesburg (Lamont J sitting as court of first instance):

The appeal is dismissed with costs.

JUDGMENT

Navsa ADP & Pillay JA (Maya JA, Malan, JA et Swain AJA concurring)

[1] The respondent, East London Own Haven (ELOH), an association incorporated in terms of s 21 of the Companies Act 61 of 1973, trading under the name and style of Own Haven Housing Association, instituted an action in the South Gauteng High Court, against the appellant, Coface South Africa Insurance Company Limited (Coface), claiming payment of an amount of R1 172 583,80 owing in terms of a construction guarantee, pursuant to a construction contract being cancelled by ELOH, ostensibly because of default on the part of a building contractor. The construction contract had been concluded between ELOH and Construct Construction (Pty) Ltd (the contractor) and provided for the completion of building works at Kenwick Close, East London.

[2] Conventionally, the construction contract required the contractor to execute a construction guarantee in favor of ELOH, in terms of which a guaranteed sum would be paid to Coface upon cancellation of the construction agreement on the basis of default by the contractor. Such a guarantee was executed by Coface in favor of ELOH and in terms thereof Coface guaranteed payment by it to ELOH of the guaranteed sum. At this stage it is necessary to have regard to clause 5.1 of the construction guarantee which provided that Coface undertook to make payment upon receipt of a first written demand from

ELOH, calling up the construction guarantee and stating that:

'The agreement has been cancelled due to the Contractor's default and that the Construction Guarantee is called up in terms of 5.0. The demand shall enclose a copy of the notice of cancellation: . . . . '

[3] In its particulars of claim ELOH alleged that it had cancelled the construction contract due to the contractor's default and addressed a letter of demand to Coface as required by the terms of the guarantee referred to in the preceding paragraph.

[4] In its plea denying liability, Coface sought to contest ELOH's assertion that it was entitled to cancel because of default on the part of the contractor. Indeed, it blamed ELOH for faulty design and denied that the contractor had defaulted on its obligations and thus denied that it was liable to pay in terms of the guarantee.

[5] ELOH excepted to this defence, which was based on the construction agreement and disputes in relation thereto. ELOH contended that such a defence was precluded by reason of the terms of the guarantee and was bad in law. The exception was heard by Satchwell J in the South Gauteng High Court. The learned judge had regard to a number of decisions of this court and, relying on the decision in *Dormell Properties 282 CC v Renasa Insurance Co Ltd & others NNO* 2011 (1) SA 70 (SCA), she dismissed ELOH's principal exception. In this regard, Satchwell J at para 37 of her judgment said the following:

'In the present case, the fact is that there is only one ground permitted for cancellation which would render the insurer liable. That ground is the statement that cancellation is due to the contractors default. All that is required is a statement. But, as has been exemplified in *Dormell* supra, that statement can be successfully challenged and the employer may be denied its claim to the guaranteed sum.'

[6] Thus fortified, and before the commencement of the trial in the high court before Lamont J, Coface applied to amend its plea to introduce a defence on the following basis:

6.1 The final amount payable by the contractor to the ELOH was finally determined by the issue of a final payment certificate (incorrectly labelled interim payment certificate) which certificate purported to set out an amount constituting the recovery of an overpayment by the plaintiff to the contractor which was due by the contractor to the

plaintiff.

6.2 That a recovery statement had been issued simultaneously with that certificate reflecting an amount of R nil recoverable by the ELOH from the contractor as damages.

6.3 That the issue of the certificate finally determined that the contractor did not owe any amount to the ELOH as a result of the alleged breach of contract by the contractor.

6.4 In the premises Coface was not obliged to make the payment in terms of the guarantee as the indebtedness due to the ELOH by the contractor did not fall within its terms.

[7] It was accepted by Coface that there had been a mis-description by ELOH in relation to the payment certificate and that it was an interim certificate rather than a final one. Coface nevertheless contended that, notwithstanding that it was an interim certificate, it reflected a nil balance and thus became the final certificate because no further certificates had been issued.

[8] The application to amend was opposed. It was agreed by the parties that, in the event of the application for amendment being dismissed, ELOH would be entitled to judgment in the following terms:

‘3.1 Payment of R1 172 583-80;

3.2 Interest on the aforesaid amount at the rate of 15.5 % per annum from 6 February 2009 to date of payment;

3.3 Cost of suit including the qualifying fees of Dean Arthur Jacoby.’

[9] In deciding the application to amend Lamont J had regard to the purpose of a construction guarantee, namely, to enable the person relying thereon to readily obtain payment by production of the required documents. Put simply, he held that a guarantee of the kind under consideration was enforceable according to its terms. The introduction of extraneous issues as a defence is precluded, save for very limited exceptions like fraud. He sought to distinguish *Dormell* on the basis that, in that case, it was impossible for the plaintiff to establish an entitlement to its claim. Returning to the facts before him, Lamont J took the view that the interim certificate did not become a final certificate by

reason of no further certification. He dismissed the application for amendment with costs, including the costs consequent upon the employment of senior counsel and gave judgment in favour of ELOH in the terms set out in para 8 above.

[10] It is that decision which is before us with the leave of the court below. In *Edward Owen Engineering Ltd v Barclays Bank International Ltd* [1978] 1 All ER 976 (CA), Lord Denning MR considered letters of credit and the law in relation thereto, and stated:

'It has been long established that when a letter of credit is issued and confirmed by a bank, the bank must pay it if the documents are in order and the terms of the credit are satisfied. Any dispute between buyer and seller must be settled between themselves. The bank must honor the credit.'

He continued:

'To this general principle there is an exception in the case of what is called established or obvious fraud to the knowledge of the bank.'

[11] Turning his attention to what the English refer to as performance bonds, which is the equivalent of performance or construction guarantees, [1] Lord Denning went on to state:

'So, as one takes instance after instance, these performance guarantees are virtually promissory notes payable on demand. So long as the Libyan customers make an honest demand, the banks are bound to pay and the banks will rarely, if ever, be in a position to know whether the demand is honest or not. At any rate they will not be able to prove it to be dishonest. So they will have to pay.

All this leads to the conclusion that the performance guarantee stands on a similar footing to a letter of credit. A bank which gives a performance guarantee must honour that guarantee according to its terms. It is not concerned in the least with the relations between the supplier and the customer; nor with the question whether the supplier has performed his contracted obligation or not; nor with the question whether the supplier is in default or not. The bank must pay according to its guarantee, on demand if so stipulated, without proof or conditions. The only exception is when there is a clear fraud of which the bank has notice.'

[12] In *Loomcraft Fabrics CC v Nedbank Ltd & another* 1996 (1) SA 812 (A) at 816G – 817A, this court stressed the autonomous nature of obligations by banks to a beneficiary under a letter of credit. It had regard to *Edward Owen* and stated the following:

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[1] *Minister of Transport and Public Works, Western Cape v Zanbuild Construction (Pty) Ltd* 2011 (5) SA 528 (SCA), para 13.

'The importance of allowing banks to honour their obligations under irrevocable credits without judicial interference has been repeatedly stressed in subsequent cases. In *Intraco Ltd v Notis Shipping Corporation (The Bhoja Trader)* [1981] 2 Lloyd's Rep 256 (CA) Donaldson LJ, after upholding the refusal of the Court below to interfere with the seller's right to call upon a bank to make payment under its guarantee where fraud was not involved, observed at 257:
"Irrevocable letters of credit and bank guarantees given in circumstances such as that they are the equivalent of an irrevocable letter of credit have been said to be the lifeblood of commerce. Thrombosis will occur if, unless fraud is involved, the Courts intervene and thereby disturb the mercantile practice of treating rights thereunder as being the equivalent of cash in hand."
Lord Denning MR in *Power Curber International Ltd v National Bank of Kuwait SAK* [1981] 3 All ER 607 (CA) at 613*b* sounded a similar warning:
"No foreign seller would supply goods to that country on letters of credit because he could no longer be confident of being paid. No trader would accept a letter of credit issued by a bank of that country if it might be ordered by its courts not to pay."'

[13] In *Lombard Insurance Company Ltd v Landmark Holdings (Pty) Ltd* 2010 (2) SA 86 (SCA) para 20, this court said the following:
'The guarantee by Lombard is not unlike irrevocable letters of credit issued by banks and used in international trade, the essential feature of which is the establishment of a contractual obligation on the part of a bank to pay the beneficiary (seller). This obligation is wholly independent of the underlying contract of sale and assures the seller of payment of the purchase price before he or she parts with the goods being sold. Whatever disputes may subsequently arise between buyer and seller is of no moment insofar as the bank's obligation is concerned. The bank's liability to the seller is to honour the credit. The bank undertakes to pay provided only that the conditions specified in the credit are met. The only basis upon which the bank can escape liability is proof of fraud on the part of the beneficiary. This exception falls within a narrow compass and applies where the seller, for the purpose of drawing on the credit, fraudulently presents to the bank documents that to the seller's knowledge misrepresent the material facts.'

[14] *Dormell* indicated a divergence. Bertelsmann AJA, writing for the majority, after referring to *Lombard* and *Loomcraft*, stated that:
'In principle therefore, the guarantee must be honoured as soon as the employer makes a proper claim against it upon the happening of a specified event. In the present case there is no suggestion that Dormell did not properly demand payment of the guaranteed sum. In the normal course of events payment should have been effected within seven days of demand.'

Seemingly reaffirming what is set out in this court's preceding decisions, Bertelsmann AJA then had regard to an arbitration award pursuant to the construction contract which was in favour of the contractor. At paras 41 and 42 of the *Dormell* judgment the following appears:

'[41] There is no longer any dispute about the cancellation of the underlying agreement that still has to be resolved. The arbitration has established that Dormell is in the wrong. Its repudiation of the building contract was held to have been unlawful. As a consequence, Dormell has lost the right to enforce the guarantee. There remains no legitimate purpose to which the guaranteed sum could be applied.

[42] If it were to be ordered to honour the guarantee, Renasa or Synthesis would be entitled to repayment of the full amount guaranteed. Hudson & Wallace *Hudson's Building and Engineering Contracts* 11 ed para 17.078, quoted in *Cargill International SA and Another v Bangladesh Sugar and Food Industries Corp* [1996] 4 All ER 563 (QB Com Ct) at 570*b-f* states:

"It is generally assumed, and there is no real reason to doubt, that the Courts will provide a remedy by way of repayment to the other contracting party if a beneficiary who has been paid under an unconditional bond is ultimately shown to have called on it without justification . . . In cases where there has been no default at all on the part of the contractor, there would additionally be a total failure of consideration for the payment."

See further *General Surety & Guarantee Co Ltd v Francis Parker Ltd* (1977) 6 BLR 18 (QBD Commercial List) at 20.'

[15] In *Dormell* Cloete JA, writing for the minority at para 61, succinctly described the legal relationships that arise in relation to construction guarantees and associated construction agreements. The clause in terms of which the construction guarantee in *Dormell* could be called up is similar to the one presently under discussion. At para 63 Cloete JA said the following:

'The appellant complied with the provisions of clause 5. It was not necessary for the appellant to allege that it had validly cancelled the building contract due to the second respondent's default. Whatever disputes there were or might have been between the appellant and the second respondent were irrelevant to the first respondent's obligation to perform in terms of the construction guarantee. That is clear from the passages quoted by my learned colleague in para [38] of his judgment, from *Lombard Insurance Co Ltd v Landmark Holdings (Pty) Ltd*; and *Loomcraft Fabrics CC v Nedbank Ltd*; and also from . . . the judgment of Lord Denning MR in *Edward Owen Engineering Ltd v Barclays Bank International Ltd*: . . . . '

[16] Cloete JA recorded that there was no suggestion of fraud on the part of the employer. At paras 64 and 65 he said:

'[64] Once the appellant [the beneficiary] had complied with clause 5 of the guarantee, the first respondent [the guarantor] had no defence to a claim under the guarantee. It still has no defence. The fact that an arbitrator has determined that the appellant was not entitled to cancel the contract, binds the appellant – but only *vis-á-vis* the second respondent [the employer]. It is *res inter alios acta* so far as the first respondent is concerned. As the cases to which I have referred above make abundantly clear, the appellant did not have to prove that it was entitled to cancel the building contract with the second respondent, as a precondition to enforcement of the guarantee given to it by the first respondent. Nor does it have to do so now.

[65] For these reasons, it is not in my view bad faith for an employer, who has made a proper demand in terms of a construction guarantee, to continue to insist on payment of the proceeds of the guarantee, when the basis upon which the guarantee was called up has subsequently been found in arbitration proceedings between the building owner and the contractor to have been unjustified. I would add that the fact that the arbitrator's award is final as between the appellant and the second respondent does not mean that it is correct, or that the appellant would have to set it aside before calling up the guarantee, much less that the appellant is acting in bad faith in seeking to enforce payment under the guarantee against the first respondent.'

[17] At this stage it is necessary to consider cases that have come before this court after *Dormell* dealing with letters of credit and construction guarantees.

[18] In *Casey v First Rand Bank Ltd* (608/2012) [2013] ZASCA 131 this court, in relation to a letter of credit, had to deal with an assertion that the principal debt had prescribed. The guaranteeing bank's client sought a declarator to that effect, submitting that the claim that the client had made upon the bank knowing that the claim had prescribed was fraudulent. It was contended that the effect of a declarator that the debt had prescribed was to extend the ambit of legitimate challenges to a letter of credit beyond the narrow confines of the fraud exception. In *Casey,* Swain AJA noted that:

'[12] . . . An irrevocable letter of credit is not accessory to the underlying contract and is distinguishable in law from a suretyship which is accessory to the principal obligation. See *Absa Bank Bpk v De Villiers* 2001 (1) SA 481 (HHA).'

Later, he confirmed:

'[14] The distinction sought to be drawn on behalf of Casey and Kimberley is without merit. The issue of the irrevocable letter of credit by the Bank of America in favour of Firstrand, established a contractual obligation on the Bank of America to pay Firstrand as beneficiary, provided that the

conditions specified in the credit were met. Reciprocal obligations in these terms were created by the letter of credit between the Bank of America and Firstrand. An order declaring that Firstrand had no right to draw-down on the letter of credit, must inevitably have as a consequence that the Bank of America was not obliged to honour this draw-down claim. Such an order would infringe upon the autonomy of the irrevocable letter of credit. The argument was advanced simply to circumvent the autonomy of the letter of credit.'

[19] In *First Rand Bank Limited v Brera Investments CC* (385/2012) [2013] ZASCA 25, this court was faced with a situation where the guaranteeing bank sought to rely on events that occurred after demand had been made in terms of the guarantee. In that regard the decision in *Dormell* was relied upon. Malan JA, preferred the minority view in *Dormell*. At para 11 of *Brera*, the autonomy of letters of credit, demand guarantees, performance bonds and similar documents was restated. The dictum in *Lombard* referred to above was reaffirmed. In *Brera* it was in any event held that *Dormell* was distinguishable on the facts.

[20] In *Guardrisk Insurance Company Ltd v Kentz* (Pty) Ltd (92/2013) [2013] ZASCA 182, a case heard in the same term as the one presently under discussion, payment of a performance guarantee in relation to a construction contract was in issue. There too disputes arose concerning the principal contract and whether there had been proper cancellation of that agreement. A further point arose in that case namely, whether the guarantees were conditional. It was held that they were unconditional guarantees. In the present case it is not disputed that the construction guarantee is unconditional.

[21] In *Guardrisk* Theron JA said the following concerning the unconditional construction guarantees there under consideration:

'[13] The terms of the guarantees are clear. They create an obligation on the part of the guarantor (Guardrisk) to pay Kentz (the employer) on the happening of a specified event. It was recorded in the guarantees that notwithstanding the reference to the construction contract, the liability of the bank as principal is absolute and unconditional, and should not be construed to create an accessory or collateral obligation. The guarantees go further and specifically state that the bank may not delay making payment in terms of the guarantees by reason of a dispute between the contractor and the employer. The purpose of the guarantees was to protect Kentz in the event that Brokrew could not perform its obligations in terms of the construction contract.'

In this regard reference was made to *Lombard*, *Loomcraft* and *Edward Owen.*

[22] Theron JA, like Malan JA in *Brera*, indicated a preference for the approach of the minority in *Dormell*.

[23] The reliance by the majority in *Dormell* on *Cargill* is misplaced. First, that case involved, as contesting litigants, the parties to the principal contract and did not involve a dispute between the guaranteeing bank and beneficiary. It was a case involving injunctive relief. The plaintiffs in that case applied for an injunction restraining the defendants from drawing on the bond. Certain issues were referred to trial. In *Cargill* the sanctity of performance bonds was reaffirmed. The court in *Cargill* stated that a bond is in effect 'as valuable as a promissory note' and that it has to be met, pending the resolution of the contractual disputes. To do otherwise, so the court stated in *Cargill*, would be to frustrate the commercial purpose of the bond. Put simply, the court in *Cargill* held that performance bonds had to be met according to their terms and that disputes concerning the principal agreement could be dealt with later.

[24] Since the decision in *Dormell* and perhaps predictably, there has been an increasing number of cases in which guaranteeing banks have sought to introduce contractual disputes in order to avoid meeting the guarantee. In some cases the allegedly defaulting contractor sought to join the fray. It is the very consequence that the line of cases prior to *Dormell* sought to avoid.

[25] Moreover, in *Dormell*, in dealing with claims for repayment after a bond has been met, Bertelsmann AJA cited a passage from Hudson & Wallace *Hudson's Building and Engineering Contracts* 11 ed para 17.078 as further justification for a financial institution not paying when default on the part of a contractor was disputed. That passage, referred to in para 14 above, states that there would additionally be a total failure of 'consideration' for the payment. First, it should be noted that the English doctrine of consideration is not part of our law of contract. [2] Second, Cloete JA in *Dormell*, at para 66, demonstrated why the reliance on that passage in *Hudson* was fallacious. The decision of the majority in *Dormell* was clearly wrong.

[2] *Conradie v Rossouw* 1919 AD 279 and R H Christie & G B Bradfield *Christie's The Law of Contract n South Africa* 6 ed (2011) at 8 to 10.

[26] It was accepted on behalf of the appellant that, in the event of such a conclusion, the appeal should fail. The following order is made:
The appeal is dismissed with costs.

M S NAVSA
ACTING DEPUTY PRESIDENT

R PILLAY
JUDGE OF APPEAL

APPEARANCES:

FOR APPELLANTS:	P Ellis SC Instructed by: Larson Falconer Hassan Parsee Inc, Johannesburg Symington & de Kok, Bloemfontein
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THE SUPREME COURT OF APPEAL
REPUBLIC OF SOUTH AFRICA

MEDIA SUMMARY – JUDGMENT DELIVERED IN THE SUPREME COURT OF APPEAL

From: The Registrar, Supreme Court of Appeal
Date: 02 December 2013
Status: Immediate

Please note that the media summary is intended for the benefit of the media and does not form part of the judgment of the Supreme Court of Appeal.

Coface South Africa Insurance Co Ltd v East London Own Haven t/a Own Haven Housing Association

The Supreme Court of Appeal today dismissed an appeal by Coface South Africa Insurance Co Ltd. against the judgment of the South Gauteng High Court, Johannesburg. Coface had executed a construction guarantee in favour of the respondent, East London Own Haven pursuant to a construction contract it had entered into with Construct Construction (Pty) Ltd.

The construction contract was cancelled by the respondent which then called up the construction guarantee. Coface refused to honor it claiming that the cancellation was not the result of the default of the contractor but that of the respondent.

The court held that the construction guarantee which had to be honored save in cases where it has been established that the claim thereon was tainted by fraud on the part of the claimant, in this case the respondent. It was completely independent of any dispute that might exist in terms of the

principle construction contract and consequently found that Coface was liable to make payment to the respondent.