Construction Guarantees Is the Liability on an Insurer Absolute and Unconditional?

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It is often common practice in the construction industry for clients awarding construction contracts to building contractors to insist that the contractor furnish a guarantee from an acceptable party, in terms of which a guaranteed sum is payable to the client upon cancellation of the contraction contract on the basis of default on the part of the contractor. Such guarantees, which are regularly issued by insurance companies as part of their carrying on Short-Term Insurance business, provide for the insurer undertaking to make payment upon receipt of a first written demand from the beneficiary calling up the guarantee.

In practice insurers have frequently attempted to avoid liability under the guarantee on the grounds that the client was not entitled to cancel the agreement, that the contractor was not in default of its obligations or that the problems experienced by the client were caused by faulty design rather than the conduct of the contractor.

The traditional argument advanced by beneficiaries to a construction guarantee is that the purpose of such a guarantee is to enable the beneficiary to readily obtain payment for loss suffered through the conduct of the contactor by the production of the documentation specified in the guarantee. The guarantee was enforceable according to its terms and the introduction of extraneous issues as a defence was precluded, save for a few limited exceptions such as fraud. This approach has its origin in the English Law relating to letters of credit issued by banks which required a bank which had issued and confirmed a letter of credit to pay if the documents provided to it were in order and the terms of the LOC were satisfied, any dispute between the parties to the underlying contract to be determined by those parties alone. The English courts regarded performance bonds, which are the equivalent of a contraction guarantee to be "*virtually promissory notes payable upon demand*". (see *Edward Owen Engineering Ltd v Barclays Bank International Ltd 1978 1 All ER 976 (CA)*). The party who issues such a guarantee must honour the guarantee according to its terms and must not become concerned in the relationship between the parties to the underlying contract and whether the contractor is in default or not. It must pay on demand without proof of conditions.

This approach was followed by the courts in South Africa (see e.g. *Loomcraft Fabrics CC v Nedbank Ltd & another 1996 (1) SA 812 (A))* on the basis that banks should honour their obligations under irrevocable letters of credit without judicial interference, so long as fraud was not involved on the grounds that such documents were the lifeblood of commerce . Rights obtained by such contracts should be treated *'as the equivalent of cash in hand'*.

The approach adopted by the Appeal Court in the *Loomcraft* case was affirmed by the Supreme Court of Appeal in 2010 as being applicable to performance guarantees, in the case *Lombard Insurance Company Ltd v Landmark Holdings (Pty) Ltd 2010 (2) SA 86 (SCA)*the court viewing such guarantees as being not unlike letters of credit issued by banks. The obligation of the issuer is wholly independent of the underlying contract and whatever disputes may arise between the parties to the underlying agreement is of no importance to the liability of the issuer who is liable if the conditions specified by the guarantee are met. The only basis upon which liability can be avoided is proof of fraud on the part of the beneficiary.

However, following upon the decision of the Supreme Court of Appeal in the case of *Dormell Properties v Renasa Insurance Co Ltd NNO 2011 (1) SA 70 (SCA)* decided only a year after the *Lombard* case, the traditional view of the guarantor's liability was called into serious question.

In the *Dormell* case, Bertlesmann AJA, who delivered the majority judgement, 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".

However, despite this finding, the Judge then curiously proceeded to have regard to an arbitration award made in favour of the contractor. The arbitration had taken place in terms of the contract concluded between the client and the contractor which found that the client's repudiation of the contract had been unlawful. The Court reasoned that as a consequence of the arbitration finding the beneficiary had lost the right to enforce the guarantee against the insurer which had issued it and there '*remained no legitimate purpose to which the guaranteed sum could be applied'*.

This approach seemed to equate the liability of the insurer under the guarantee as that of a co-principal debtor whose liability depended upon the liability of the main debtor, the contractor in terms of the construction contract, rather than one arising from an independent agreement. The guarantee issued by the insurer was viewed as accessory to the underlying contract. This view contrasted sharply with the view of the minority judges, as set out by Cloete JA, who stated that whatever disputes there were or might have been between the client and the contractor, these were irrelevant to the insurers obligation to perform in terms of the construction guarantee and there was no need for the beneficiary to allege that it had validly cancelled the building contract due to the contractor's default. The minority judges specifically approved of the *Loomcraft Fabrics* and *Lombard* decisions as well as the judgement of Lord Denning MR in the *Edward Owen Engineering* case.

It would not be long before the confusion created by the *Dormell* would come back before the SCA. In 2013 the SCA had to again decide whether to follow the reasoning of the majority or minority judges in the *Dormell* case, this time in the matter of *Coface South Africa Insurance Co Ltd v East London Own Haven (Case No 050/2013)*. The Court after conducting a thorough analysis of all the previous decisions referred to as well as its own decisions on the liability of banks in terms of Letters of Credit given after the *Dormell* decision, concluded that *Dormell* had been wrongly decided and that the liability of a guarantor in terms of a performance guarantee was absolute and unconditional. The Court acknowledged without qualification that "the decision of the majority in *Dormell* was clearly wrong".

The wheel has now come full circle and it can now be regarded as settled law that the liability of an insurer who issues a Construction Guarantee is absolute and unconditional subject only to the terms of the guarantee being fulfilled and there being no fraud on the part of the beneficiary.