Shipping & Transport - South Africa

Performance guarantees in shipbuilding agreements

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April 30 2014

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A common feature of shipbuilding agreements is the requirement that parties provide guarantees from third-party institutions – such as banks or insurers – as security for the performance of their respective obligations under the contracts in question.

The legal nature and practical effect of this type of security are routinely a source of dispute and litigation internationally, often as a result of the uncertainty introduced by the way in which contracting parties choose to name the instrument (eg, bonds, guarantees or performance security).

The recent Supreme Court of Appeal case of *Guardrisk Insurance Company Ltd v Kentz (Pty) Ltd* provides a fresh opportunity to summarise the approach of the South African courts.

What must be determined first is whether the guarantee is 'conditional' or 'on demand'. The essential difference between the two is that the party making a claim under a conditional guarantee is required, at a minimum, to allege and – depending on the terms of the guarantee – establish liability on the part of the non-performing party for the same amount. An on-demand guarantee requires no allegation of liability on the part of the non-performing party. All that is required for payment is a demand by the claimant, stated to be on the basis of the event specified in the guarantee.

The guarantee type depends on the terms of the document, as interpreted by the courts. For example, a guarantee will normally be found to be on demand where it records that the guarantor's liability, as principal, is absolute and unconditional and cannot be construed to create an accessory or collateral obligation. Another relevant factor is whether the guarantee records that the guarantor may not delay in making payment by reason of a dispute between the parties to the underlying contract.

An exception to the guarantor's obligation to pay arises in the event of fraud. If a beneficiary makes a call on a guarantee knowing that it is not entitled to payment, the courts will step in to protect the provider of the guarantee and refuse to order its enforcement.

The fraud exception falls within a narrow compass and applies where:

> "*the seller, for the purpose of drawing on the credit, fraudulently presents to the confirming bank documents that contain, express or by implication, material representations of fact that to his knowledge are untrue*."

In other words, mere error, misunderstanding or oversight, however unreasonable, does not amount to fraud; nor is it sufficient to show that the beneficiary's contentions were incorrect. The party alleging fraud has to show that the beneficiary knew it to be incorrect and that the contention was advanced in bad faith.

The finding in *Guardrisk* is usefully summarised in the following passage:

> "*Our courts, in a long line of cases and also relying on English authorities, have strictly applied the principle that a bank faced with a valid demand in respect of a performance guarantee, is obliged to pay the beneficiary without investigation of the contractual position between the beneficiary and the principal debtor. One of the main reasons why courts are ordinarily reluctant to entertain the underlying contractual disputes between an employer and a contractor when faced with a demand based on an on demand or unconditional performance guarantee, is because of the principle that do so would undermine the efficacy of such guarantees.*"

From a practical perspective, parties to shipbuilding agreements should guard against relying on the name ascribed to a guarantee instrument at face value. Instead, they are

encouraged to ensure that the substance of the instrument reflects their intention as to its legal effect and, if necessary, to obtain the appropriate advice when drafting its terms.

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