

**Tinus Maritz**

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## **Doubts raised on the validity of construction and payment guarantees**

*Peer reviewed*

### **Abstract**

It has become common practice in the building industry for contractors to provide employers with a construction guarantee. These guarantees, which are defined as being on call or on demand, usually provide that a certificate issued by the agent or the principal agent will provide conclusive proof that the employer is entitled to call in the guarantee (Fenster, 1998). In a number of recent decisions, such a conclusive proof provision has been the subject of judicial scrutiny, and there is now an ever-increasing doubt as to the validity of these guarantees.

The Joint Building Contracts Committee (JBCC) 1991 suite of contracts was the first in South Africa to introduce the concept of construction and payment guarantees that provided the requisite cover available on call from approved financial institutions. In the process the construction guarantee replaced the performance guarantee (surety) that prevailed in addition to the retention fund in construction contracts. Various standard forms, which embodied the terms and conditions of the guarantees, were prepared for this purpose by the JBCC. These terms and conditions had been negotiated by the JBCC with the legal/technical committees of the banking and insurance institutions and were fully approved by them. However, for some time now concerns have been raised regarding the difficulties experienced in getting all banks and/or their property finance divisions to comply with the JBCC guarantees. Because the construction and payment guarantees are so closely linked to the terms and conditions of the JBCC principal and nominated/selected subcontract agreements, changes made to the *pro forma* guarantees or agreements, which disturb the risk of the guarantor, could very well render the guarantee null and void.

This article will report the interpretation of construction and payment guarantees as held in recent court decisions, the findings of an investigation conducted on perceived problems being experienced by the South African construction industry with regard to these guarantees, and will present what is considered to be best practice to ensuring the continued effective use thereof.

**Keywords:** Building industry, guarantees, performance, risk management, securities

## Abstrak

Deesdae is dit algemene praktyk vir aannemers in die boubedryf om aan bouhere 'n konstruksiewaorborg te voorsien. Hierdie waarborge, wat gedefinieer word as beskikbaar op aanvraag of oproep, voorsien gewoonlik dat 'n sertifikaat wat deur die agent of die hoofagent uitgereik word afdoende bewys sal wees dat die bouheer geregtig is om die waarborg op te roep (Fenster, 1998). In 'n aantal onlangse hofuitsprake het hierdie ongekwalifiseerde toepassing van oproepbaarheid in gedrang gekom weens regterlike ondersoek en daar bestaan nou 'n groterwordende twyfel oor die geldigheid van hierdie waarborge.

Die Gesamentlike Boukontraktekomitee (GBK) se 1991-kontraktetestel was die eerste in Suid-Afrika om die konsep van konstruksie- en betalingswaarborge in te stel. Hierdie waarborge verskaf die vereiste dekking wat, wanneer dit benodig sou word, deur goedgekeurde finansiële instellings beskikbaar gestel word. Hiermee is die prestasiewaorborg (borgakte), wat naas die retensiefonds algemeen in konstruksiekontrakte in gebruik was, deur die konstruksiewaorborg vervang. Die GBK het verskeie standaardvorms, wat die terme en voorwaardes van die waarborge omvat het, vir hierdie doel voorberei. Die GBK het op 'n deurlopende grondslag met die regs- of tegniese komitees van die bank- en versekeringsinstansies oor gemelde terme en voorwaardes onderhandelinge gevoer ten einde hulle volle goedkeuring en die ongekwalifiseerde toepassing daarvan te verseker. Daar word egter reeds vir 'n geruime tyd kommer uitgespreek oor die probleme wat ondervind word om te verseker dat al die banke en/of hul eiendomfinansieringsafdelings die terme en voorwaardes van die GBK-waarborge nakom. Omdat die terme en voorwaardes van die konstruksie- en betalingswaarborge ten nouste verbind is met dié van GBK se hoof boukontrakoooreenkomste en genomineerde of geselekteerde subkontrakoooreenkomste, mag wysigings aan die *pro forma*-waarborge en -ooreenkomste – wat verband hou met die risiko van die waarborggewer – daartoe lei dat hierdie waarborge van nul en gener waarde is.

Onlangse hofbeslissings met betrekking tot die interpretasie van konstruksie- en betalingswaarborge en bevindinge van 'n ondersoek na beweerde probleme wat deur die Suid-Afrikaanse konstruksiebedryf ondervind word met betrekking tot die waarborge word in hierdie artikel rapporteer, en 'n beste praktyk riglyn om te verseker dat hierdie waarborge steeds effektief gebruik word, word voorgestel.

**Sleutelwoorde:** Boubedryf, waarborge, prestasie, risikobestuur, sekuriteit

## 1. Introduction

Uncertainty about future events creates the potential of losses occurring, because available security often does not completely liquidate the exposure, and inevitable losses are accepted as part of property finance. Efforts to reduce the severity and variability of such losses are an ongoing risk management function requiring the constant monitoring, developing and refining of policies, procedures, skills and knowledge (Wight & Ghyoot, 2008).

In an effort to reduce risks and to protect the interests of the contracting parties, various types of securities have over the years

been introduced into standard building agreements. As the contents of agreements became more sophisticated and included new provisions, inventive ways are continuously being developed to protect the risks and interests of the parties with greater certainty. Therefore, when the JBCC's new parcel of contract documents was introduced to the South African building industry in 1991, Brink & Botha (1991: 2) pointed out that the aims of the JBCC, *inter alia*, were to:

- Review the areas of uncertainty that exist in the documents then in use;
- Re-examine the distribution of risks;
- Find a way of improving cash flow to the contractor and his subcontractors;
- Provide better and more cost-effective security to the employer, and
- Encourage better and greater discipline in the industry.

It is essential that the project team establishes and understands clients' requirements as accurately and as quickly as is appropriate and possible, and these requirements must reflect their needs and objectives. The Latham Report (1994) suggested that the project needs of a client are:

- Obtaining value for money;
- Ensuring the project is delivered on time;
- Having satisfactory durability;
- Incurring durable running costs;
- Being fit for its purpose;
- Being free from defects on completion;
- Having an aesthetically pleasing appearance, and
- **Being supported by meaningful guarantees** (author's emphasis).

A number of standard contracts are currently being used in South Africa. According to the South African Construction Industry Status Report, prepared by the Construction Industry Development Board (CIDB 2004: 50), the following forms of contract were considered to be meeting the principles of modern contracting if utilised unaltered:

- *Fédération Internationale des Ingénieurs-Conseils* (FIDIC – French acronym for International Federation of Consulting Engineers);

- General Conditions of Contract for Construction Works (GCC 2010);
- New Engineering Contract (NEC – now referred to as the Engineering and Construction Contract, ECC), and
- The Joint Building Contracts Committee (JBCC Series 2000).

These modern forms of contracts are supposed to appropriately allocate risks, responsibilities and obligations and contain administrative procedures that enable proactive management of the delivery process. As part of their supplementary documents these contracts offer *pro forma* deed of suretyship and guarantee forms. Informal observation that will be evaluated in this article has indicated that these forms are regularly changed leading to poor interpretation and increased risk to the contracting parties.

This article focuses primarily on the guarantees incorporated into the JBCC Series 2000 suite and more specifically on its variable construction guarantee, which must be provided by the contractor/subcontractor, and its payment guarantee, which must be provided by the employer/contractor.

In the absence of a specific agreement, the contractor is generally not obliged to provide any form of security for the due fulfilment of his obligations. Loots (1995: 647) stated, however, that it is customary to require the contractor to furnish a security of the contractor's performance of the contract with an undertaking to be bound in a specified sum until (and unless) such performance is achieved. The security may either be in the form of a suretyship or a performance (or "on-demand") guarantee or indemnity. Forsyth & Pretorius (1992: 26) defined suretyship as:

*an accessory contract by which a person (the surety) undertakes to the creditor of another (the principal debtor), primarily that the principal debtor, who remains bound, will perform his obligation to the creditor, and secondarily, that if and so far as the principal debtor fails to do so, the surety will perform it or, failing that, indemnify the creditor.*

The performance (or "on-demand") guarantee, on the other hand, is usually an undertaking whereby the guarantor unconditionally and irrevocably undertakes to pay certain amounts (as may be specified in the agreement) on demand and without proof of any breach of contract. According to Uff (2009: 345) the notice usually requires no more than an assertion of default on behalf of the contractor and the money will be paid irrespective of any disputes that may exist, either in relation to the underlying contract, generally, or in relation to the purported reason for calling the security, in particular.

It is also the opinion of Uff (2009: 346) that the demand for this type of security has increased as international trade and construction in particular have grown.

## **2. JBCC construction guarantees**

The 1991 edition of the JBCC suite of documents was the first in South Africa to introduce the concept of a construction guarantee aimed at replacing the retention fund. In the process the construction guarantee also replaced the performance guarantee that, at that time, prevailed in addition to the retention guarantee in construction contracts (Finsen, 2005: 100). Both performance guarantees and retention guarantees were initially drafted in the form of a suretyship, which – after the guarantor had been made a co-principal debtor and had renounced his benefits of excussion and division – still had the defence in law of challenging the right of the employer to call up the guarantee and to challenge the quantum of the guarantee before paying over the money. In short, a suretyship is not tangible money. It has to be earned, often by taking recourse to the courts (Uff, 2009: 344).

The standard guarantee forms, which were prepared by the JBCC in their earlier editions, did not guarantee payment of loss once established. According to McDonald (2002), problems initially existed in the wording. In the matter of *Basil Read (Pty) Ltd v Beta Hotels (Pty) Ltd and Others* 2001, Judge Van Reenen stripped the JBCC 1991 construction guarantee of all its guarantee status and dignity, exposing it for what it really was, namely a simple suretyship. The current JBCC Series 2000 guarantees have rid themselves of the words “in respect of expense and loss”, and the destroyer of all guarantees, “by virtue of non-performance”, in an effort to provide the market with a “true blue” guarantee, without the cumbersome obligations of a suretyship.

The wording of the construction guarantee (JBCC Code 2122, 2007c), relevant part quoted below for ease of reference, now makes it explicitly clear that the guarantor undertakes to pay the employer the certified amount upon receipt of the following three prescribed documents, which will serve as conclusive proof that the employer is entitled to call up the guarantee:

1. A copy of a first written demand issued by the employer to the contractor stating that payment of an amount certified by the principal agent in an interim or final payment certificate has not been made in terms of the agreement and, failing such

payment within seven (7) calendar days, the employer intends to call upon the guarantor to make payment.

2. A first written demand issued by the employer to the guarantor at the guarantor's physical address with a copy to the contractor stating that the period of seven (7) calendar days has elapsed since the first written demand, and that the amount certified has still not been paid, therefore the employer calls up the construction guarantee and demands payment from the guarantor.
3. A copy of the said payment certificate which entitles the employer to receive payment in terms of the agreement.

Understandably employers prefer to receive 'on-demand' guarantees because these guarantees can be called up without having to first prove the contractor's default in arbitration or litigation, which can be costly and time consuming. Guarantors likewise prefer 'on-demand' guarantees because in this instance they do not need to read the building agreement, investigate the contractor's alleged default and assess the employer's entitlement to compensation (Uff, 2009: 345).

The current JBCC construction guarantee provides, in clauses 4 and 5, for specific JB events that would trigger an obligation on the guarantor to make payment in terms of the guarantee. Clause 4 deals with those circumstances where the principal agent issued a certificate certifying a balance due by the contractor to the employer. There is no concomitant duty on the employer to account to the guarantor as the statement by the principal agent already justifies the amount due and payable by the contractor to the employer. Clause 5 contemplates two different trigger events, namely:

1. Cancellation of the contract by the employer, due to the default by the contractor, or
2. Sequestration/liquidation of the contractor.

Clause 5 reads as follows:

*Subject to the Guarantor's maximum liability referred to in 1.0 or 2.0, the Guarantor undertakes to pay the Employer the guaranteed sum or the full outstanding balance upon receipt of a written demand from the Employer to the Guarantor at the Guarantor's physical address calling up this Construction Guarantee stating that:*

- 5.1 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; or

- 5.2 A provisional sequestration or liquidation order has been granted against the Contractor and that the Construction Guarantee is called up in terms of 5.0. The demand shall enclose a copy of the Court order.

In the event where the guarantor receives a demand under 5.1 or 5.2 of the guarantee, it is obliged to pay the full amount for which it is liable in terms of the guarantee. Clause 7 provides that where a claim is made by the employer he shall, after completion of the works, account to the guarantor and shall submit an expense account showing how all monies received have been expended and shall refund to the guarantor any resulting surplus.

The JBCC construction guarantee constitutes a principal obligation on the part of the guarantor and is an independent contract between the guarantor and the employer, totally separate from the principal agreement. This fact is reiterated by clause 3 of the guarantee which states that any reference in the guarantee to the agreement is for purposes of convenience only and shall not be construed to create any accessory obligation. See JBCC Code 2201, 2007e for a summary of all the available construction guarantees (security) to be provided by the contractor.

### **3. JBCC payment guarantees**

Relevant to the South African construction industry, a payment guarantee could be defined as a contractual undertaking by a third party, the guarantor, towards the contractor, that the guarantor will pay to the contractor the amount of works done under the construction contract, up to the guaranteed amount or a percentage of the price of the works done, in case the employer defaults in its payment obligations.

Of the four CIDB endorsed contract documents (*supra*), only the FIDIC Redbook and the JBCC PBA contracts expressly provide for the use of payment guarantees. (See clause 3.1, JBCC Principal Building Agreement, Code 2101, PBA 2007a and the example clause on page 17 of the guidance notes of the FIDIC Redbook). Both contracts have *pro forma* payment guarantee forms that could be used by the parties.

In terms of the JBCC Agreement the employer is obliged to provide a payment guarantee (JBCC Code 2124, 2007d) if he requires the

contractor to waive his lien, and likewise if the contractor states in his tender that he requires such guarantee. The onus is on the contractor to specify the amount of the guarantee required in his tender as there are no specific percentages provided in the principal agreement as is the case with the construction guarantee. Finsen (2005: 106) remarks that little guidance can be offered to a tenderer as to what would be an appropriate amount, and if the tenderer should stipulate for an amount disproportionately higher than his competitors, he runs the risk of the rejection of his tender.

In the nominated/selected subcontract agreement (JBCC N/SA Code 2102, 2007b) the quantum, however, is given and a payment guarantee shall be provided by the contractor for an amount equal to 10% of the subcontract sum.

#### **4. General**

The JBCC's *pro forma* construction and payment guarantees are simple documents that make no attempt to describe in detail the specific liabilities of the guarantor and its obligation is restricted to the payment of the guaranteed sum. The guarantees do not impose on the guarantor any obligations that are separate from, or in addition to, those assumed by the contractor/employer. By the same token, by being bonded, the parties assume no additional obligation that they have not already assumed by their agreement or by operation of the law. The guarantee can be invoked only if the defaulting party is in breach of contract and the guarantee must be in writing and signed to be enforceable.

#### **5. Recent court decisions summarised**

##### **5.1 *Sasfin (Pty) Ltd v Beukes*<sup>1</sup>**

This case arose after Sasfin, a financier, agreed to loan money to Beukes, a doctor. A number of the provisions in their written contract were attacked as being unconscionable and therefore against public policy and unenforceable.

The Appellate Division focussed on two clauses, in particular. The first provided that the amount owing by Beukes would be determined and proved by a certificate issued by a director of Sasfin, and the second that such certificate would constitute conclusive proof of the amount owing. The effect of these two clauses was therefore that Sasfin would determine how much was owed and once it had

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<sup>1</sup> *Sasfin (Pty) Ltd v Beukes* 1989 (1) SA 1 (A).

issued the certificate Beukes would be obliged to pay the amount certified.

The matter went to the courts and the Appellate Division found that the contract was unconscionable, against public policy and therefore illegal. The question which then arose was whether these certificates would always be invalid or whether they were invalid in certain citations only. Two subsequent decisions were obliged to interpret *Sasfin v Beukes* and they came to conflicting decisions on this point. In the first, *Nedbank Ltd v Abstein Distributors (Pty) Ltd*, the court held that a conclusive proof certificate will always be invalid. In the second decision, *Donnelly v Barclays National Bank Ltd*, the court found that the effect of the *Sasfin* case was not to render all conclusive proof certificates invalid.

The Appellate Division was approached for a ruling and asked to assess whether conclusive proof certificates are always invalid or whether they will be invalid under prescribed circumstances only. It found that conclusive proof certificates will be valid, legal and enforceable when the author of the certificate is someone who has some measure of independence from the creditor.

The important question is, therefore, whether the agent in a construction contract is sufficiently independent of the employer. One would argue that the agent is sufficiently distant in most cases, especially when appointed under the JBCC Agreement, but if the agent is a permanent employee of the employer, then he may not be sufficiently distanced and the guarantee will therefore be invalid and unenforceable.

## **5.2 AB Construction v Furstenburg Property Development & Others (2009)<sup>2</sup>**

AB Construction (contractor) concluded a standard JBCC building contract in connection with the construction of a residential development in East London. The contractor arranged for Constantia Insurance Company (guarantor) to provide for the requisite construction guarantee in favour of Furstenburg Property Developments (employer). During the course of the contract various disputes arose between the contractor and employer, which resulted in the employer, after issuing an appropriate breach notice, cancelling the agreement.

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2 *Petric Construction CC t/a AB Construction v Toasty Trading t/a Furstenburg Property Development and Others 2009(5) SA 550 ECG*

Foreseeing the probability that the employer would try and call in the construction guarantee, the contractor requested the guarantor not to accede to any demand under the guarantee, but the guarantor explained that it was bound to honour the guarantee unless the contractor was able to obtain a court interdict prohibiting payment under the guarantee. The court agreed that the construction guarantee is analogous to a letter of credit and held further that the disputes between the contracting parties had nothing to do with the obligations of the guarantor to honour the guarantee. The fact that the employer's cancellation was disputed by the contractor or whether or not the employer was in material breach at the time of its purported cancellation were considered to be wholly irrelevant to the guarantor's liability to pay.

As a result the court found that the employer, having complied with the requirements of the guarantee and there being no evidence of any fraud, the guarantor was obliged to make payment in terms of the guarantee.

### **5.3 *Lombard Insurance Co Ltd v Landmark Holdings (Pty) Ltd and Others (2010)*<sup>3</sup>**

A construction company had been liquidated and the employer had called up the guarantee in terms of the conditions specified in the document. Lombard (guarantor) paid the amount demanded, thereafter seeking reimbursement from Landmark (Landmark having agreed to indemnify the guarantor in the event that it had to meet its obligations under the guarantee). Landmark refused to indemnify the guarantor on the basis that the principal agent, in terms of the underlying construction agreement, had perpetrated a fraud in order to obtain the benefits of the guarantee.

The lower court, finding in favour of Landmark, dealt with the matter on the basis that the guarantee had to be considered in conjunction with the underlying construction contract. On appeal, the Supreme Court of Appeal (SCA) ruled that as the guarantor had undertaken to pay, upon liquidation of the construction company, and the guarantee having been called up in accordance with its conditions, the guarantee was payable. As the guarantee had to be construed independently of the underlying construction contract, and as there was no obligation on the guarantor to investigate the propriety of the claim, payment by the guarantor was validly made.

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3 *Lombard Insurance Co Ltd v Landmark Holdings (Pty) Ltd and Others (2010)* (2) SA 86 SCA

#### **5.4 Kwikspace Modular Buildings Ltd v Sabadala Mining Company Sarl and Nedbank Ltd (2010)<sup>4</sup>**

The SCA was called again to determine whether the contractor could rely on a term in the building contract to interdict the employer from presenting the guarantee to the bank for payment. The courts regard on-demand bonds independently of the underlying contract (*supra*); a guarantor is therefore obliged to make payment in terms of an on-demand bond presented to it provided only that the conditions specified in the bond are met. This is clearly confirmed by the following quote from the judgment of the SCA, in the recent *Lombard* decision.

*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 on which the bank can escape liability is proof of fraud on the part of the beneficiary.*

The underlying contract in this matter provided that it was subject to Australian law and Kwikspace (contractor) argued that, because of this fact, the contract contains a clause qualifying the right of the employer to present the guarantee. The lower court had found that the building contract did not contain a clause qualifying the right of the employer to present the guarantee, and on that basis the contractor's application to interdict the employer from presenting the guarantee failed. The SCA expressly refrained from considering whether there was any room for a contention that the position in South Africa should be the same as in Australia, i.e. that an underlying building contract between the contractor and employer could, as a matter of law, qualify the right of the employer to present an unconditional guarantee for payment to a guarantor. The decision of the lower court was upheld.

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<sup>4</sup> *Kwikspace Modular Buildings Ltd v Sabadala Mining Company Sarl and Nedbank Ltd* (2010) SCA

### **5.5 *Dormell Properties v Renasa Insurance Company and Others (2010)*<sup>5</sup>**

Synthesis Projects Cape (Pty) Ltd (contractor) entered into an agreement with Dormell Properties 282 CC (employer) for the construction of a shopping centre. It became apparent at the beginning of February 2008 that practical completion would not be achieved before the expiry date of the guarantee, namely 28 February 2008. In light of this the principal agent demanded that the contractor arrange for the construction guarantee to be extended until 15 April 2008, failing which the employer would cancel the contract.

The contractor refused to extend the guarantee and the employer then cancelled the contract on the 28<sup>th</sup> of February 2008. A demand was submitted on the same day to Renasa Insurance Company (guarantor) for payment of the amount available under the guarantee on the basis that the contract was cancelled by the employer, which is one of the grounds for calling up the guarantee. The contractor disputed the employer's right to cancel the contract which was treated as a repudiation of the contract. The dispute was referred to arbitration and the arbitrator found that the termination of the contract by the employer was invalid as he had no right to do so.

The issue initially came before the Johannesburg High Court and it held that the employer was not entitled to the rectification of the guarantee and that in any event the guarantee had expired at midnight on 27 February 2008 before it had been called up. The employer appealed this decision to the SCA.

On the issue of the expiry of the guarantee the SCA held that where time has to be computed in accordance with a contract, one looks first at the terms of the contract. In this case the contract clearly expressed the expiry date of the guarantee being 28 February 2008 and there was accordingly no warrant for construing the guarantee as having expired prior to that date.

On the issue of rectification, the SCA held that it was obvious to all the parties that the beneficiary of the guarantee was intended to be the employer under the contract. The SCA, however, held that the effect of the arbitrator's award in favour of the contractor was to destroy the basis upon which the employer had called up the guarantee, namely the employer's cancellation of the contract, and as such the employer has lost the right to enforce the guarantee.

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<sup>5</sup> *Dormell Properties 282 CC v Renasa Insurance Company Ltd and Others (491/09) SCA*

The SCA accordingly ruled that the guarantor was not obliged to pay out under the guarantee and dismissed the employer's appeal. The SCA nonetheless affirmed the nature of the JBCC guarantee as being a demand guarantee akin to a letter of credit. In other words all that is required ordinarily to obtain payment is compliance with the formalities specified in the guarantee.

### **5.6 *Minister of Transport and Public Works, Western Cape v Zanbuild Construction (2011)*<sup>6</sup>**

The SCA was once again called upon to consider the legal nature of construction guarantees in South African law. The facts of the matter, briefly stated, were as follows. Two independent, but substantially similar, guarantees were issued by ABSA Bank Ltd (Absa) in favour of the Western Cape Department of Transport and Public Works (Department), as security for the obligations of Zanbuild Construction (Pty) Ltd (Zanbuild) under two separate construction contracts. The guarantees provided *inter alia* that, "... the bank been given 30 (thirty) days written notice of its intention to do so, provided the employer shall have the right to recover from the bank the amount owing and due to the employer by the contractor on the date the notice period expires."

Absa notified the Department in writing that it wished to withdraw the guarantees, and that each of the guarantees would be cancelled thirty days from the date of the written notice, whereafter no further claims or payments would be considered by Absa. Upon receipt of Absa's notice, the Department demanded immediate payment of the full amount of both guarantees citing, as its basis for such demand, that Zanbuild was in default under both contracts.

Zanbuild, in the Western Cape High Court, applied for an interdict preventing the Department from claiming, and Absa from paying, the amounts claimed under the guarantees. The interdict was granted with leave to appeal to the SCA.

On appeal, Zanbuild's contention was the guarantees were not "on-demand guarantees" but rather "conditional guarantees" and argued that Absa's liability under the guarantees was akin to a suretyship relationship in that the guarantees were inextricably linked to the contracts. As such, Zanbuild argued, Absa's liability under the guarantees was limited to the extent that the Department can demonstrate a monetary claim against Zanbuild under the contracts

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<sup>6</sup> *The Minister of Transport and Public Works, Western Cape v Zanbuild Construction* 2011 SCA 10

prior to the withdrawal of the guarantees. The Department, on the other hand, argued that the guarantees were in fact on-demand guarantees and that all that was required from the Department in order to obtain payment of the full amount of the guarantees, was to demand payment under the guarantee and provide a statement to Absa that Zanbuild was in default under the contracts.

The Court remarked that the question as to whether or not a guarantee is conditional or on demand is dependent on the interpretation of the terms of the guarantee concerned, and found that, on its interpretation of the terms of the guarantees, the guarantees were not on-demand but rather conditional guarantees. The reasons for the Court's finding were *inter alia* as follows: first, the Court held that the language and content of the guarantees were akin to suretyships in that the guarantees provided that they were provided as "security for the compliance of the contractor's performance of obligations in accordance with the contract" and the "due and faithful performance by the contractor" and, secondly, the guarantees provided that "with each payment under this guarantee the bank's obligation shall be reduced pro rata". As such, the Court held, this was a clear indication that the Department's interpretation of the guarantee (i.e. that any default of Zanbuild under the contracts irrespective of liability on the part of Zanbuild would render the full amount of the guarantees payable) was clearly incorrect, and if this interpretation were correct, there would be no need for multiple draw downs on the guarantees.

The Court consequently held that, as the Department had failed to establish that, prior to the withdrawal of the guarantees by Absa, the amounts claimed by the Department from Absa were due to it by Zanbuild, the Department was not entitled to demand payment under the guarantees from Absa and dismissed the Department's appeal.

## **6. Investigation into perceived problems being experienced with regard to construction and payment guarantees**

### **6.1 Research methodology**

To establish quantitative criteria whereby the effectiveness of the guarantees could be evaluated, a questionnaire was circulated via email to a target population of randomly selected contractors and employers in the Gauteng province in order to capture the requisite data. The target population was divided into the following two categories:

1. Contractors – A selection of main contractors in the building industry that are registered with the Construction Industry Development Board (CIDB) with a Grading Designation of at least 7.
2. Employers – A selection of clients or developers undertaking and being responsible for the funding of larger building projects (the party engaging in contract with the contractor).

Respondents were requested to respond to nine statements dealing with the application and effectiveness of the JBCC construction and payment guarantees on condition that the following instances were present, namely:

- A recognised bank or insurance company provides the guarantees;
- JBCC construction and payment guarantees are utilised;
- JBCC terms and conditions are applicable, and
- Work to be executed is building-related.

A 5-point Likert scale ranging from "strongly agree (SA)" to "strongly disagree (SD)", where SA represented 5 and SD 1, respectively in the frequency tables hereinafter, was deemed appropriate for all statements. One hundred and six questionnaires were emailed to the target population of which 31 emails failed to deliver (user unknown) and a further three emails were returned with the comment that the questionnaire was not applicable to their knowledge field. Of the 72 emails read, 18 responses were obtained, 11 of which were from contractors and the balance from developers, which represented a 25% response rate (see Table 1).

A qualitative approach that utilised personal interviews was adopted to obtain the requisite data from the banking sector which underwrites construction and payment guarantees for the South African building industry. The target population was made up of representatives from the legal departments of the selected five 'mainstream' banks, who were deemed-to-be knowledgeable on the application of the JBCC guarantees. The content and purpose of the study were first explained to these representatives, whereafter structured interviews (see Table 2) were conducted in order to ascertain perceptions and viewpoints on the importance, application and effectiveness of the JBCC guarantees.

Due to the small size of the target populations in both the quantitative and qualitative approaches the surveys did not require sampling. Every effort to eliminate the likelihood of biased data was made,

but should such data be identified, it is acknowledged. Buys (cited in Buys & Tonono, 2007: 80) defines bias as “any influence, condition, or set of conditions that may singly or together distort the data from what may have been obtained under the conditions of pure chance”.

Subsequent to these methods of data-gathering, three selected deemed-to-be knowledgeable individuals on the application of the JBCC guarantees (D'Arcy-Donnelly, Spence & Fourie, 2008) were contacted via email, two of whom were employed in the legal departments of corporate financial property divisions acting as separate divisions from their main banks, and the other the CEO of the Master Builders South Africa (MBSA). This was done to obtain a more complete picture of the sourced data. These three individuals were asked to respond to only one question; i.e. what the impact is should a guarantor tamper with the wording of the guarantees as has been agreed between the JBCC and the banking sector. The results of these communications are included in the comments following Table 2.

## 6.2 Trends indicated by the data collected

Table 1: Application of the JBCC construction and payment guarantees as viewed by contractors and developers

| <i>Statement</i> |  |    | SA<br>5 | A<br>4 | N<br>3 | D<br>2 | SD<br>1 | Mean |
|------------------|--|----|---------|--------|--------|--------|---------|------|
| 1                | The introduction of construction guarantees provided by financial institutions in place of the retention fund and performance surety has been well accepted by all stakeholders in the building industry             | No | 5       | 10     | 3      | 0      | 0       | 4.1  |
|                  |  | %  | 28%     | 56%    | 17%    | 0      | 0       |      |
| 2                | The obligation on the parties to furnish construction and payment guarantees is so fundamental that failure to do so by the start of the construction period is sufficient grounds for cancellation of the agreement | No | 7       | 5      | 1      | 3      | 2       | 3.7  |
|                  |  |    | 39%     | 28%    | 6%     | 17%    | 11%     |      |

| Statement |   |    | SA<br>5 | A<br>4 | N<br>3 | D<br>2 | SD<br>1 | Mean |
|-----------|---|----|---------|--------|--------|--------|---------|------|
| 3         | The reduced cover in the 5 <sup>th</sup> edition of the JBCC construction guarantees remains adequate to protect the interests of the employer    | No | 5       | 9      | 4      | 0      | 0       | 4.1  |
|           |   | %  | 28%     | 50%    | 22%    | 0      | 0       |      |
| 4         | Lack of uniformity in the wording of construction and payment guarantees often results in inadequate or defective protection                      | No | 4       | 10     | 3      | 1      | 0       | 3.9  |
|           |   | %  | 22%     | 56%    | 17%    | 6%     | 0       |      |
| 5         | The construction and payment guarantees are truly 'on-demand' guarantees  | No | 0       | 5      | 11     | 1      | 1       | 3.1  |
|           |   | %  | 0       | 28%    | 61%    | 6%     | 6%      |      |
| 6         | Construction guarantees curtail the liquidity of established contractors  | No | 2       | 9      | 2      | 4      | 1       | 3.4  |
|           |   | %  | 11%     | 50%    | 11%    | 22%    | 6%      |      |
| 7         | Construction guarantees are available to emerging contractors   | No | 5       | 10     | 2      | 0      | 1       | 4.0  |
|           |   | %  | 28%     | 56%    | 11%    | 0      | 6%      |      |
| 8         | The lapsing of the construction guarantee after its expiry date leaves the employer with little recourse against the contractor                   | No | 5       | 2      | 2      | 6      | 3       | 3.0  |
|           |   | %  | 28%     | 11%    | 11%    | 33%    | 17%     |      |
| 9         | Employers are often caught unawares in that the construction guarantee lapses because the expiry date on the guarantee is generally set too early | No | 3       | 4      | 6      | 3      | 2       | 3.2  |
|           |   | %  | 17%     | 22%    | 33%    | 17%    | 11%     |      |

The responses to the statements in Table 1 are reported in the order corresponding with the statements in the table, together with the respective mean.

1) The respondents indicated that the introduction of on-demand guarantees has been well accepted by the industry (mean = 4.1)

and 2) that it is an obligation on the parties to furnish such guarantees at the commencement of the project (mean = 3.7). 3) The reduced cover currently available to employers should the contractor default was regarded as still adequate (mean = 4.1). 4) The respondents indicated a concern that amendments to the *pro forma* wording of the guarantees may result in inadequate or defective protection (mean = 3.9). 5) The respondents were undecided whether banks will make payment forthwith when called upon. This can possibly be attributed to the fact that they may not have had any experience in this regard as no demands for payment had previously been lodged by them (mean = 3.1). 6) The respondents generally were in agreement that liquidity of established contractors is curtailed by having to provide guarantees (mean = 3.4) and 7) that this is more prevalent in the case of emerging contractors when considering the respective percentages in the Table (mean = 4.0). 8) The respondents were not overly concerned that the lapsing of the construction guarantee might leave the employer with little recourse against the contractor for rectification of latent defects (mean = 3.0) nor 9) that employers might be unaware that the expiry date on construction guarantees might be set too early that may leave them without protection (mean = 3.2).

Table 2: Application of the JBCC construction and payment guarantees as viewed by the banking sector

| Statement |  |    | SA<br>5 | A<br>4 | N<br>3 | D<br>2 | SD<br>1 | Mean |
|-----------|--|----|---------|--------|--------|--------|---------|------|
| 1         | Underwriting JBCC guarantees is an important commercial business for banks | No | 5       | 0      | 0      | 0      | 0       | 5.0  |
|           |  | %  | 100%    | 0      | 0      | 0      | 0       |      |
| 2         | JBCC guarantees are regarded as "true blue" guarantees on-demand           | No | 5       | 0      | 0      | 0      | 0       | 5.0  |
|           |  | %  | 100%    | 0      | 0      | 0      | 0       |      |
| 3         | Banks do not get involved in the dispute between contracting parties       | No | 5       | 0      | 0      | 0      | 0       | 5.0  |
|           |  | %  | 100%    | 0      | 0      | 0      | 0       |      |

| <i>Statement</i> |  |    | SA<br>5 | A<br>4 | N<br>3 | D<br>2 | SD<br>1 | <i>Mean</i> |
|------------------|--|----|---------|--------|--------|--------|---------|-------------|
| 4                | Banks are kept informed on the latest revisions of the guarantee forms as and when published by the JBCC   | No | 0       | 1      | 0      | 4      | 0       | 2.4         |
|                  |  | %  | 0       | 20%    | 0      | 80%    | 0       |             |
| 5                | The standard JBCC guarantee forms are available on banks' electronic server system and the wording is not tampered with                              | No | 1       | 3      | 0      | 1      | 0       | 3.8         |
|                  |  | %  | 20%     | 60%    | 0      | 20%    | 0       |             |
| 6                | Except for what is referred to in the guarantee form banks do not require any additional documentation to be submitted when a guarantee is called up | No | 0       | 4      | 1      | 0      | 0       | 3.8         |
|                  |  | %  | 0       | 80%    | 20%    | 0      | 0       |             |
| 7                | Data on turnover and number of guarantees called up are annually collected and made available  | No | 0       | 0      | 0      | 5      | 0       | 2.0         |
|                  |  | %  | 0       | 0      | 0      | 100%   | 0       |             |

The findings in Table 2 are based on the responses provided by the selected representatives of the five 'mainstream' banks in South Africa (ABSA, FirstRand Bank, Nedbank, Rand Merchant Bank and Standard Bank) and are reported in the order corresponding with the statements in the table together with the respective mean.

1) All the interviewees regarded the underwriting of JBCC guarantees as an important part of the banks' day-to-day business (mean = 5.0). 2) There was consensus among the interviewees regarding the undertaking by banks to pay out the amount available on call or on demand without getting involved in the dispute (mean = 5.0), and 3) that banks do not unilaterally amend the wording of the guarantees (mean = 5.0). 4) The interviewees, however, acknowledged that they are not always informed about the revised wording of new editions as and when issued by the JBCC (mean = 2.4). 5) They agreed that the forms are readily available on their systems and that the wording is not tampered with (mean = 3.8) and 6) that they would adhere to the conditions in the guarantee when a guarantee is called up (mean = 3.8). 7) No statistics on the application of the

guarantees are kept by banks although all interviewees agreed after being confronted by the interviewer that such information will have significant value (mean = 2.0).

The statements dealing with uniformity in the wording of the guarantees in Table 1 (statement 4) and Table 2 (statement 5) did not clearly correspond with each other and the responses received were not entirely helpful when attempting to interpret the impact that tampering with the wording of the guarantees has had on the industry, and also with what the industry has experienced in this regard through casual observation by the author. Further investigation was deemed necessary and the author proceeded to contact specific deemed to be knowledgeable individuals for further information. This investigation revealed that the responses would have been significantly different in Table 2 if responses were based on the policies adopted by the mainstream banks' corporate property finance divisions, particularly those of Nedbank Corporate Property Finance and FNB Corporate Property Finance, the institutions that were contacted. This was especially the case when a payment guarantee forms part of the development loan finance structure between the property finance institution and the client/borrower.

According to these interviewees, the wording of the payment guarantee the bank would give to the contractor (normally in exchange for a waiver of the builder's lien from the contractor) has to incorporate the following additional aspects that the JBCC payment guarantee does not provide for:

- The JBCC payment guarantee is for a fixed amount and usually equivalent to three months projected payments at any one time. A property development loan is approved on the basis of a defined expenditure amount. In the event of valid variations issued in terms of the JBCC contract between the employer and the contractor, the bank's guaranteed amount would, in terms of the wording of the guarantee, inherently guarantee these additional amounts occasioned by the variations, notwithstanding that the bank has not agreed to the variations (there is no mechanism for this). The net effect by the end of the project is that the bank's total loan exposure could be substantially higher than the total amount originally approved.
- Property finance institutions generally have a standard requirement that the work, while signed off by the relevant professional, must be vetted by the bank's agent before

payment is made. It is not always possible for the bank to rely solely on the professional's sign-off, as they do not owe the bank a duty of care, nor does the bank obtain cession of their professional indemnity cover, nor can the bank always ensure that the cover is up to date and valid. The fact that the bank utilises its agent to verify the works is not uncommon and, in fact, prudent.

- Banks issue a guarantee which indicates the full facility available to the contractor. This amount does not always constitute the full contract amount and the employer may be required to initially pay a portion from his/her own resources. The JBCC guarantee does not provide a mechanism where banks do not guarantee the full contract amount.
- The guarantees by property finance institutions provide for payments to be made on a balance to complete. In other words, upon payment of a draw, the bank must have a sufficient facility to fund the completion of the work. A typical example of such an amendment is the insertion of the following subclause in the payment guarantee:

*The Guaranteed Amount shall be reduced automatically to the extent that the value of the remaining portion of the Works is less than the value of the Guaranteed Sum. Accordingly, on final completion of the Works, as contemplated in the original scope of the works, the Guaranteed Sum shall be nil*

- Inherent in the above is the fact that banks do not automatically assume full liability for all and any overruns. In the event that a "buffer" facility is required by the contractor over and above the agreed contingency amount provided, this would need to be a defined amount and the borrower/ employer would need to furnish the bank with appropriate security for this additional facility. This is an additional credit risk which banks do not automatically assume as is envisaged by the JBCC payment guarantee, but if banks were required to assume it, it would need to be quantified and secured.
- The expiry date in the JBCC payment guarantee does not necessarily coincide with the bank's facility. If a loan is settled from the proceeds of the units as they are transferred, the contingent liability that remains in terms of the guarantee would necessitate banks holding back the proceeds from the transfers pending finalisation of the accounts which may take some time. This would clearly not be acceptable to the employer/borrower.

- As the JBCC payment guarantee is normally a standard annexure to the JBCC contract, it is usually the employers who find themselves in a difficult position. This is due to the fact that they are legally required to procure the financial guarantee in accordance with the annexure, which they may be unable to do under certain of the above circumstances.

## 7. Conclusion

The research has identified that the JBCC guarantees have largely met the aims set by the JBCC (*supra*), but that the following problem areas exist, which may have an influence on the effectiveness of the guarantees:

- The insistence by banks (more specifically their corporate property finance institutions) to amend or add special conditions to the wording of the *pro forma* JBCC guarantees.
- It is generally accepted that contractors are more exposed to risk of payment default towards the end of the contract and final account stage, and acceptance of the insertion of any additional subclauses (*supra*) would dilute the contractors' protection, as and when the guaranteed sum gets exhausted.
- Contractors require the payment guarantee to expire only on payment of the final payment certificate, which date cannot be accurately determined at the start of the construction period, but banks insist on an expiry date that is certain.
- The principal agent's certification is final and constitutes a liquid document, but often payment guarantees are subject to the bank's own quantity surveyor or valuer's approval, which is not acceptable to contractors as such a provision could be abused by the issuing financial institution.
- Banks are uncomfortable with their position where the employer and contractor have agreed to numerous variation orders, resulting in a substantial increase in the original contract amount, without notifying the bank and allowing the bank to participate in the discussions in order to protect its own interest. It appears that the bank may be at risk where no certificate is issued in circumstances where substantial variations to the original contract were agreed to.
- Regardless of whether or not the Courts' interpretations of the guarantees are correct, it is likely that the decision, *inter alia*,

in the *Zanbuild* case (*supra*), will cause some confusion as to the legal nature of construction and payment guarantees in South African law, and in light of this and other decisions, prudent developers and contractors should ensure that the language of the guarantees purporting to be on-demand construction and payment guarantees do in fact entitle them to claim amounts owing, on demand. A failure to do so could potentially result in them having no claim under the construction and payment guarantee concerned.

According to the SA Builder (2008), the national government, local government and private companies who award tenders to contractors are all too familiar with the dangers within the construction industry. Contractors likewise must ensure that their risks are covered as best it can be managed and not leave it to when the problem manifests. Those that will benefit most are those who can best decrease the damage caused by these inherent dangers by:

- Recognising the characteristics of problems so that they can be identified when they appear;
- Utilising techniques to manage risks when they appear;
- Applying methods to minimise losses that occur, and
- Profiting from these risks.

One of the tools available to manage risk includes the transfer of risk, but no company will be willing to accept such an agreement without careful analysis and taking due care. The next step is the credibility of the guarantee. The third party itself must be respected, so that an employer/contractor/subcontractor will accept the guarantee. It should, however, be appreciated that the JBCC construction and payment guarantees are 'stand alone' documents where the conditions are set by the bank or issuing institution, and that these conditions are not affected by a change in the wording of the building agreement which is to be signed.

## **8. Recommendation**

The JBCC provides model forms of building agreements to the Southern African building industries including performance and payment guarantees, which are mostly issued by financial institutions such as banks and their respective property finance divisions. The wording, format, etc. have, from time to time, been discussed and agreed with some of the major banks through the legal commission of the Banking Council. In terms of recent developments, certain banks, and more specifically their property finance divisions, have

experienced problems in particular to payment guarantees. For this reason these banking and insurance institutions often wish to customise the wording of standard forms for their specific requirements. However, they should be made aware of the fact that such modifications could affect the validity of these guarantees, and that this practice could increase the risk of the parties concerned.

It is therefore recommended that the JBCC and the legal commission of the Banking Council, as well as other relevant stakeholders such as the MBSA and the South African Property Owners Association (SAPOA) should engage more regularly to discuss and find solutions for the problems that have been identified in this study including other concerns that may be voiced from time to time. The CEO of the JBCC (Bold, 2008) confirmed that regular meetings were held soon after the introduction in 1991 of the JBCC suite of contracts, but that it has for some time now largely been neglected, mainly because of the poor attendance by delegates from the Banking Council.

The demand of construction and payment guarantees that provide the requisite cover available on call from approved financial institutions has increased as international and construction work, in particular, have grown. Informal observation has indicated that frequent requests are being made by neighbouring countries for the use of the local developed standard forms of contract, more particularly the JBCC. This article has revealed that considerable problems remain in the application of the 'on-demand' guarantees as endorsed by the JBCC. It is therefore a matter of great importance that these issues be dealt with fully in the discussions between JBCC, the banks and other stakeholders, so that the industry can benefit as a result of better risk management by employers and contractors, which, in turn, should assist in the effective administration and the overall reduction of cost of construction projects.

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