

Short notes on:

## **GUARANTEES IN CONSTRUCTION CONTRACTS – SOME IMPORTANT NOTES**

### ***Introduction***

In the construction industry, as with many other industries, guarantees are used as security for the payment of compensation and to secure the performance of the obligations of the employer and/or the contractor in the underlying building contract. In construction contracts, it is far more common to secure the performance of the obligations of the contractor, and accordingly, only these are considered for purposes of this article. Such a security, has the purpose of protecting the employer against failure by the contractor to perform its obligations in terms of the construction contract.

### ***Reasons for guarantees during construction works***

There could be various circumstances where an employer in a construction contract may require the contractor to put up security for due performance in terms thereof. These usually include situations where the contractor:

- fails to repay an advance in the instalments required, or to provide the materials or goods for which such advance payment was made; or
- fails to achieve the performance specifications set out in the construction contract; or
- fails to rectify a defect during the defects liability period (also quite often referred to as 'advance payment', 'performance', and 'retention guarantees/bonds'), or
- is sequestrated or placed in liquidation or under business rescue, or
- breaches the construction contract resulting in the employer cancelling the contract.

The above is a non-exhaustive list and, as previously mentioned, does not include examples of where the contractor may require the employer to put up a guarantee, merely due to the rarity of the latter.

### ***Surety- vs. on-demand guarantees***

There may be certain restrictions applicable to guarantees, and for this purpose, it is necessary to briefly differentiate between a “surety guarantee”, where the guarantor’s obligation to pay is dependent upon a breach of the construction contract or another liability of the contractor in terms thereof; and an “on-demand guarantee”, which is payable merely upon demand by the employer stating that an event triggering payment in terms of a guarantee has occurred, and usually presenting the document to the guarantor, without having to establish the contractor’s breach.

The guarantor under a surety guarantee, in essence, undertakes to pay the employer a certain amount which the contractor is obliged to pay in terms of the construction contract, or from a liability arising therefrom. Thus, the employer must prove the contractor’s breach or liability otherwise from the construction contract, which is usually at the completion of adjudication, arbitration, or litigation proceedings, which can be a lengthy and costly process, especially with arbitration and litigation. It is for this reason that banks are sometimes unwilling to issue surety guarantees - to avoid being dragged into lengthy construction disputes.

On-demand guarantees, on the other hand, are principal, independent, autonomous and self-regulatory contracts between the guarantor and the employer. It is separate from construction contracts and enforceable on its own terms. The liability of the contractor to make payment in terms of the guarantee, is not reliant on any breach or other liability arising from the construction contract. With these types of guarantees, courts are sometimes reluctant to interfere to prevent that their autonomous nature is undermined. Traditionally, and confirmed in *Guardrisk v Kentz*<sup>1</sup>,

---

<sup>1</sup> [2013] ZASCA 182 (SCA)

the court would only grant an interdict against payment of a guarantee, where fraud is clearly established.

It is clear that on demand guarantees poses a significant risk to the contractor in terms of being abused by the employer. It is for this reason that certain restrictions can be imposed on the employer. A few examples are listed as follows<sup>2</sup>:

- construction contracts could prescribe specific events where an employer is entitled to claim in terms of an on-demand guarantee;
- construction contracts could prescribe the notice that must be given to a contractor of the employer's intention to claim in terms of the guarantee. This will enable the contractor to apply for appropriate relief;
- the demand could be required to state the breach and details thereof;
- a demand could be required to be accompanied by an applicable arbitral award, court order, or evidence of contractor's breach;
- claims can be restricted to an amount reflecting actual loss suffered by the employer; or
- a dispute resolution mechanism, such as adjudication, can be included in the demand guarantee.

In the judgment of *Kwikspace Modular Buildings Ltd v Sabodala Mining Company Sarl and Another*<sup>3</sup>, it was illustrated that restrictions on the employer's right to claim against an on demand guarantee, and conditions for making such a determination, stipulated in the construction contract, is undesirable from the employer's perspective as this takes away the autonomous nature of such a guarantee.

---

<sup>2</sup> Engineering & Construction Contracts Notes, LEAD (LSSA), Hugh Lane - 2017

<sup>3</sup> (173/09) [2010] ZASCA 15; [2010] 3 All SA 467 (SCA) ; 2010 (6) SA 477 (SCA) (18 March 2010)

## **Conclusion**

An on-demand guarantee is appropriate in the sense that it can secure an advance payment as it immediately restores the normal position during which the contractor must prove his performance and entitlement to payment. However, due to the complexities of these guarantees, and in order to reduce the likelihood of unintended consequences, employers and contractors must be expertly guided by professionals with regard to the wordings of such guarantees. Contact a professional at SchoemanLaw for assistance.

