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# FIDIC 1999 CLAUSE 4.2 PERFORMANCE SECURITY

# THE DEMAND GUARANTEE AND SURETY BOND COMPARED

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**Our courts are regularly asked to decide whether a performance guarantee issued under a construction contract is an on-demand guarantee. This is because the provider of the guarantees is probably anxious to avoid having to make payment.** Some examples where this occurred are in the matters of *Lombard Insurance Co Ltd v Landmark Holdings (Pty) Ltd & others [2009] ZASCA 71; 2010 (2) SA 86 (SCA), Eskom Holdings SOC Limited v Hitachi Power Africa 2013 JDR 2011 (SCA) and Mutual & Federal v KNS Construction (208/15) [2016] ZASCA 87 (31 May 2016)*, which were all referred to the Supreme Court of Appeal.

This article considers the provision of clause 4.2 of the FIDIC 1999 suite and the Pro Forma guarantees bound into the FIDIC Contract. Clause 4.2 requires the contractor to provide a "*Performance Security*" for the proper performance of its obligations towards the employer under the contract. The security is required to be in the amount and currencies specified in the Appendix to Tender. The employer approves the entity and the country of origin of the entity issuing the guarantee.

Such guarantee must remain valid and enforceable until the contractor has executed and completed the works and remedied any defects. If the guarantee specifies an expiry date, and the contractor has not become entitled to receive the guarantee by the date 28 days prior to the expiry date (where the work has been delayed and has not achieved completion and remedied defects), the contractor is obliged to extend the validity of the guarantee until the works have been completed and any defects have been remedied. Not doing so is a breach of contract by the contractor, which can entitle to employer to terminate the contract.

Considering the circumstances under which the employer can call on the guarantee and to protect the Contractor, the clause states:

"*The Employer shall not make a claim under the Performance Security, except for amounts to which the Employer is entitled under the Contract in the event of:*

*(a) Failure by the Contractor to extend the validity of the performance security…*
*(b) Failure by the Contractor to pay the Employer an amount due, as either agreed by the contractor OR determined under the Sub-clause 2.5 [Employer's Claims] or Clause 20 [Claims, Disputes and Arbitration], within 42 days after this agreement or determination*
*(c) Failure by the Contractor to remedy a default within 42 days after receiving the Employer's notice requiring the default to be remedied, or*
*(d) Circumstances which entitle the Employer to termination under Clause 15.2 [Termination by Employer], irrespective of whether notice of termination has been given.*

*The Employer shall indemnify and hold the Contractor harmless against and from all damages, losses and expenses resulting from a claim under the Performance Security to the extent to which the Employer was not entitled to make a claim*."

Other clauses are referenced, listing the circumstances which may result in an employer's entitlement to call on a guarantee. However, this is not enough on its own to indemnify the contractor against claims. The terms of the actual guarantee is important to understand, and this is what the challenge faced by our courts: deciding what type of guarantee was intended by the contracting parties and dissecting the terms of the guarantee to establish if it is an on-demand guarantee or otherwise.

Annexed to the FIDIC contract are pro-forma drafts of performance securities, titled (i) Demand Guarantee (Annex C), and (ii) Surety Bond (Annex D). Analysing the wording of these two pro-forma documents, the comparisons and differences can be summarised as follows:

**DEMAND GUARANTEE**

The Guarantor provides an irrevocable undertaking (equivalent to a promise) to pay the employer a specified amount in the event the employer is entitled to a claim against the contractor.

It is important to understand what it is the employer is obliged to confirm to the Guarantor to call on the demand guarantee when compared with a surety. The wording sets out clearly that all that is required is that the employer must, (i) issue the Guarantor with a simple written demand notice, containing an authenticated signature of a director (or other duly authorised person) of the employer, and (ii) a statement which only needs to state that:

- The contractor is in breach of its obligations under the contract; and
- the aspect in which the contractor is in breach.

The employer is not obliged to prove any further compliance with its obligations under the Clause 4.2 referenced clauses.

The demand guarantee stands on its own independently, not inextricably linked with the constructions contract. It is a clear contract between the Guarantor and the employer. Payment to the employer is for the full amount specified and guaranteed.

**SURETY**

The Guarantor, also, irrevocably binds itself to the employer for payment of a specified amount and for the due performance of the contractor's obligations under the contract.

The difference lies in the additional condition/s that the Guarantor binds itself for payment to the employer, upon a default by the contractor to perform a contractual obligation or upon the occurrence of any of the events and circumstances listed in sub-clause 15.2 of the conditions of the Contract. Although the use of clear wording with reference to "suretyship" or "surety" is not used, in includes wording that "*Upon Default by the Contractor to perform…the Guarantor shall satisfy and discharge the damages sustained by the Beneficiary due to such default*". In interpreting this, with emphasis on "*damages sustained*", the effect is that the employer becomes entitled to call on the surety, subject to compliance with the circumstances listed in clause 4.2 (including the further cross-referenced clauses stated therein, clause 2.5 [Employer's Claims], 20 [Claims, Disputes and Arbitration] and 15.2 [Termination by Employer]). Each of these clauses stipulate obligations to be complied with by the employer, engineer and the contractor. It further sets time periods to certain notices required.

Should the employer wish to claim against and call on the surety, the wording of this pro forma 'surety' allows for the Guarantor to investigate the employer's entitlement to a claim against the contractor and whether the employer has complied with its obligations under the construction contract, specifically, the respective conditions in the referenced clauses.

To a certain extent, the surety creates a contract between three parties, the employer, the contractor and the Guarantor. Although it is a separate contract from the construction contract, it is ancillary to the construction contract against which the contractor's performance is guaranteed. A contractor liability under the construction contract must be in place before a Guarantor liability under the surety can exist towards the employer. If the employer fails to prove its contractual entitlement to a claim, the Guarantor can be discharged from liability. Payment by the Guarantor to the employer would also only be for a proven claimed amount, which can either be the full guaranteed amount, or a portion thereof as determined and to which the employer becomes entitled to in terms of the construction contract.

Upon a default by the employer, by failing to properly administer the contract, this can result in discharge of the liability of the Guarantor. In *Administrator General South West Africa v Trust Bank of Africa Ltd 1982 (1) SA 635 (SWA)*, the Department of Water Affairs (DWA) and BVS Construction (Pty) Ltd (BVS), contracted in terms of which BVS had to perform certain work in connection with the construction of Karasburg State Water Scheme in South West Africa (construction contract). Trust Bank and BVS signed a performance bond in terms of which Trust Bank bound themselves jointly and severally unto DWA for the payment of R299 605. This bond constituted an agreement of suretyship. During the works BVS was in breach and failed performance and was also placed under provisional liquidation. They further abandoned the contract. The Director of the DWA sent notices to both BVS and Trust Bank to complete construction. Trust Bank responded that it did not intend to complete the work itself nor to employ another contractor to do so.

DWA proceeded and contracted with Mota & Ca Limitada (Mota), to complete the construction. As a result, DWA suffered damages and demanded payment from Trust Bank of the sum of R299 605. Subsequently Mota paid R100 000 to the DWA in reduction of Trust Bank's indebtedness of R299 605 and DWA pursued a claim of R199 605 against Trust Bank. Trust Bank refused to make payment, pleading that it had been discharged from liability by reason of certain conduct on the part of the DWA to which it had not been a consenting party. They relied on certain clauses under the construction contract, specifically the condition which provided that "*payment for material on site shall only be made provided the contractor can submit documentary proof that the material for which payment is claimed has been paid for by him*."

It was found that DWA failed to properly administer the construction contract in that *inter alia*, (i) The Director of the DWA certified payment to BVS in the sum of R150 267,87 in respect of reinforced steel delivered to the site on mere production of invoices and without requiring documentary proof that the contractor had paid the supplier therefor, and (ii) they contracted with Mota to complete the works at a price in excess of the price at which Mota was obliged to complete the said works in terms of a certain offer of compromise to which Mota was a party. The aforesaid was not limited and further breaches by DWA were listed in this case.

DWA breached certain conditions of the contract with BVS and as a result, the conduct was prejudicial to the interests of Trust Bank. Under those circumstances, Trust Bank was successful in their defence and the court held that they were discharged from all liability under the performance bond by reason of DWA's overpayments to BVS and to Mota to complete the works.

The pro forma documents were carefully considered in cooperation of all the relevant stakeholders from the various industries when it was drafted.

In consideration of the wording of each pro forma, for some it may seem sufficiently drafted in clear wording to easily interpret and understand the difference and the separation between a demand guarantee or a surety.

However, evidenced by the number of cases ending up in our courts to deal with the intro question stated, documents which are not clear in their wording and which cannot be properly defined, remain a risk. Rather seek proper professional advice from the industry specialist and/or experts in this regard. Too many amendment/s to already properly drafted pro forma documents, can cause confusion and create ambiguity. This then further results in a difficulty to understand the initial intention of the parties of the guarantee intended for the beneficiary and ends up in a costly and lengthy disputes between parties.