

Emergence of Illegality in the Underlying Contract as an Exception to the Independence Principle of Demand Guarantees

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Abstract

It is questionable whether illegality in the underlying contract of a demand guarantee can or should constitute a valid exception to this instrument's independence (autonomy) principle. From earlier English case law and scholarly discussions it appears that the acceptance of such an exception is contentious and, even if it is recognised, its extent remains uncertain. The English courts have previously indicated that they are open to accepting illegality in the underlying contract as an exception to the principle of independence of demand guarantees, but have not developed the exact parameters of such an exception. In the past, there were no South African court cases where illegality in the underlying contract was accepted, or even considered, as a possible exception to the independence principle of a demand guarantee. In a recent South African case, *Mattress House (Proprietary) Ltd v Investec Property Fund Ltd*, we find the first evidence of a South African High Court's willingness to accept the possibility of illegality in the underlying contract as constituting a valid exception. In this article we discuss this South African case, which provides general guidance on the possibility of accepting such an exception under the South African law. South Africa is always persuasively influenced by English law in relation to demand guarantees. Therefore, we also discuss the English law.

Keywords: demand guarantee; letter of credit; independence (autonomy) principle; illegality; exception; underlying contract



Introduction

In this contribution, we assess whether illegality in an underlying contract could and/or should constitute a valid exception to the independence principle of demand guarantees under South African and English law respectively.

A demand guarantee, also known as an independent guarantee, can briefly be described as an instrument of security issued by a financial institution (a bank or an insurance company) which provides for payment to a beneficiary of a fixed or maximum sum of money on submission of a complying demand (usually in writing and with or without additional documents) within the period of validity of the guarantee.¹

A demand guarantee is always issued by a guarantor (eg, a bank (an issuer)) as a result of an underlying contract, for instance a sale-of-goods contract or a construction contract concluded between parties to an underlying contract (eg, seller and buyer or contractor and employer). Although a guarantor issues a demand guarantee as a consequence of an underlying contract between the applicant of the guarantee (eg, buyer or employer) and the beneficiary of the guarantee (eg, seller or contractor), the guarantor is not actually concerned with this underlying contract.² It means that the payment obligation of the guarantor of the demand guarantee is not influenced by disputes or breaches of contract arising from the underlying contract between the beneficiary and the applicant of the demand guarantee; furthermore, the rights and obligations that the guarantee creates are completely separate from those arising from the underlying contract.³ If the beneficiary makes an honest and complying demand, it is irrelevant

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- 1 Michelle Kelly-Louw, 'The documentary nature of demand guarantees and the doctrine of strict compliance (Part 1)' 2009 SA Merc LJ 306 306; Michelle Kelly-Louw, 'Construing whether a Guarantee is Accessory or Independent is Key' in Charl Hugo and M Kelly-Louw (eds), *Jopie: Jurist, Mentor, Supervisor and Friend – Essays on the Law of Banking, Companies and Suretyship* (Juta 2017) 110, 111–112 ('Hugo and Kelly-Louw'); Charles Hewetson and Gregory Mitchell, *Banking litigation* (4th edn, Sweet & Maxwell 2017) 124 and 164; Roy Goode, *Guide to the ICC Uniform Rules for Demand Guarantees* (1992) ICC Publication No 510 8–9. Similarly, the International Chamber of Commerce ('ICC') defines a demand guarantee in art 2 of its 2010 Uniform Rules for Demand Guarantees (see ICC Publication 758 published in January 2010 ('URDG 758')). For more on demand guarantees, see Michelle Kelly-Louw, *Selective Legal Aspects of Bank Demand Guarantees: The Main Exceptions to the Autonomy Principle* (published LLD thesis, University of South Africa 2009) ('Kelly-Louw LLD'); James Byrne (ed), *Introduction to Demand Guarantees & Standbys* (IIBLP 2012); Robert Sharrock (ed), *The Law of Banking and Payment in South Africa* (Juta 2016) 437–458.
 - 2 Michelle Kelly-Louw, 'General Update on the Law of Demand Guarantees and Letters of Credit' in Charl Hugo (ed) *Annual Banking Law Update 2016* (2016) 43 46; Hugo and Kelly-Louw (n 1) 113–114.
 - 3 Roeland Bertrams, *Bank Guarantees in International Trade: The Law and Practice of Independent (First Demand) Guarantees and Standby Letters of Credit in Civil Law and Common Law Jurisdictions* (Springer 2013) 3; Hugo and Kelly-Louw (n 1) 113–114.

whether between itself and the applicant of the demand guarantee, as its client, it is entitled to payment, and the guarantor is not permitted to invoke defences derived from the underlying contract.⁴ The guarantor has the duty to make the payment in terms of the guarantee to the beneficiary and the applicant has the duty to reimburse the guarantor for any payments made. Any disputes (eg, breach of contract) between the applicant of the demand guarantee and the beneficiary—and any claim by the applicant that the payment of the demand guarantee was made contrary to the terms and conditions of the underlying (eg, construction) contract between them—must be resolved in separate proceedings without involving the guarantor as a party.⁵ A demand guarantee is also separate from the contract between the applicant and the guarantor, which means that the guarantor is not permitted to invoke a breach of its contract with the applicant as its client (eg, failure of the applicant to refund the guarantor for any payments made) as a defence for refusing payment when the beneficiary makes a complying demand.⁶ This is referred to as the independence (autonomy) principle of demand guarantees. This principle is well established both internationally⁷ and in South Africa.⁸

4 Bertrams (n 3) 3; Hugo and Kelly-Louw (n 1) 114; Mark Hapgood, (with contributions from Neil Levy, Mark Phillips and Richard Hooley) *Paget's Law of Banking* (12th edn, LexisNexis 2003) 730.

5 Hapgood (n 4) 730; Hugo and Kelly-Louw (n 1) 114.

6 See Kelly-Louw LLD (n 1) 63; Hugo and Kelly-Louw (n 1) 114.

7 See arts 4 and 5 of the Uniform Customs and Practice for Documentary Credits (*ICC Publication* No 600 (2006) ('UCP 600')); arts 2 and 3 of the United Nations Convention on Independent Guarantees and the Stand-by Letters of Credit (1996); art 2(b) of the 1992 Uniform Rules for Demand Guarantees (*ICC Publication* No 458 (April 1992)) ('URDG 458'); art 5(a) of the URDG 758; rule 1.06(a) and (c) of the International Standby Practices (*ICC Publication* No 590 (October 1998)) ('ISP98'). See also Howard Bennett, 'Performance Bonds and the Principle of Autonomy' (1994) *Journal of Business Law* 574; Ali Malek and David Quest, *Jack: Documentary Credits: The Law and Practice of Documentary Credits including Standby Credits and Demand Guarantees* (4th edn, Tottel Publishing 2009) 17–18 para 1.34, and para 8.17; Roy Goode, 'Abstract Payment Undertakings in International Transactions' (1996) 22 *Brooklyn Journal of International Law* 1 12; and Michael Furmston and Jason Chuah (eds), *Commercial Law* (2nd edn, Pearson 2013) 377.

8 *Firstrand Bank Ltd v Brera Investments CC* 2013 (5) SA 556 (SCA) para 11; *Dormell Properties 282 CC v Renasa Insurance Co Ltd & Others NNO* 2011 (1) SA 70 (SCA) para 39; *Compass Insurance Co Ltd v Hospitality Hotel Developments (Pty) Ltd* 2012 (2) SA 537 (SCA) para 14; *Coface South Africa Insurance Co Ltd v East London Own Haven t/a Own Haven Housing Association* 2014 (2) SA 382 (SCA) paras 11–13; *Eskom Holdings v Hitachi Power Africa* (139/2013) [2013] ZASCA 101 (12 September 2013) para 15; *Denel Soc Ltd v Absa Bank Ltd* [2013] 3 All SA 81 (GSJ) paras 30–31; *Guardrisk Insurance Company Ltd v Kentz (Pty) Ltd* [2014] 1 All SA 307 (SCA) paras 14 and 28; *Group Five Power International (Pty) Limited v Cenpower Generation Company Limited & Others* (2008/41068) [2018] ZAGPJHC 663 (16 November 2018) paras 88–89; *Lombard Insurance Co Ltd v Landmark Holdings (Pty) Ltd* 2010 (2) SA 86 (SCA) paras 19 and 20; *Union Carriage and Wagon Company Ltd v Nedcor Bank Ltd* 1996 CLR 724 (W) 731–732; *Petric Construction CC v/a AB Construction v Toasty Trading t/a*

There is an additional fundamental principle of demand guarantees which is interlinked with their independence principle: namely, that they are also documentary in character.⁹ Briefly, this means that if the beneficiary submits stipulated documents (ie, the demand and supplementary documentation) which comply with the terms of the guarantee, the guarantor is forced to pay; but if the documents do not correspond to the requirements, the guarantor is not required to pay.¹⁰ Internationally, the documentary nature of demand guarantees is also settled.¹¹

The two fundamentals of demand guarantees can be summarised as follows:¹²

The first is that the guarantor's obligation to pay in accordance with the guarantee is independent of the underlying contract (mostly a construction contract). This means that the answer to the question whether or not the guarantor must pay is determined solely with reference to the guarantee itself and not also, as in the case of an accessory (suretyship) guarantee, with reference to the underlying contract [that is, the independence principle]. This principle is subject to one well-established exception, namely fraud by the beneficiary. ... The second legal feature is that the beneficiary, to be entitled to payment, must comply with the requirements or terms of the guarantee [that is, the documentary nature].

Before we proceed, it is necessary to stress three facts. The first is that, given that the concomitant commercial and standby letters of credit¹³ are built on similar legal

Furstenburg Property Development 2009 (5) SA 550 (ECG) para 27; *Basil Read (Pty) Ltd v Nedbank Ltd* 2012 (6) SA 514 (GSJ) paras 26–28; *Casey & Another v First National Bank Ltd* 2013 (4) SA 370 (GSJ) paras 14–17 and 20–22.

9 Malek and Quest (n 7) 17 para 1.34.

10 See *Loomcraft Fabrics CC v Nedbank Ltd & Another* 1996 (1) SA 812 (A); *OK Bazaars (1929) Ltd v Standard Bank of South Africa Ltd* 2002 (3) SA 688 (SCA) 697G–698D paras 25–26; Hugo and Kelly-Louw (n 1) 114; Jason Chuah, *Law of International Trade: Cross-Border Commercial Transactions* (5th edn, Sweet & Maxwell 2013) 591; Bertrams (n 3) 3; Furmston and Chuah (n 7) 379. For a discussion of the documentary character, see Kelly-Louw (n 1) ('The documentary nature of demand guarantees'); Michelle Kelly-Louw, 'Must All the Required Documents for a Demand Guarantee be Presented at the Same Time? – *Kristabel Developments (Pty) Ltd v Credit Guarantee Insurance Corporation of Africa Limited*' (2017) THRHR 148; Michelle Kelly-Louw, 'The Doctrine of Strict Compliance in the Context of Demand Guarantees' (2016) CILSA 85; Ebenezer Adodo, *Letters of Credit: The Law and Practice of Compliance* (Oxford University Press 2014).

11 See art 5 of the UCP 600; rule 1.06(a) read with rule 1.06(d), rule 4.08 and 2.01 of the ISP98; arts 6 and 19(a) of URDG 758; art 2(b) read with art 9 of URDG 458.

12 Charl Hugo, 'Protecting the Lifeblood of International Commerce: A Critical Assessment of Recent Judgments of the South African Supreme Court of Appeal relating to Demand Guarantees' (2014) TSAR 661 662.

13 For a discussion of letters of credit, see Charl F Hugo, *The Law relating to Documentary Credits from a South African Perspective with Special Reference to the Legal Position of the Issuing and*

foundations to the demand guarantee (all share the independence principle and are documentary in nature),¹⁴ it is only natural for the law relating to the one instrument to be used as binding precedent for the other.¹⁵ Secondly, English law has in the past played, and continues to play, a vital role in the development of banking law and in particular the law relating to demand guarantees and letters of credit in South Africa.¹⁶ Finally, in both these jurisdictions, demand guarantees and letters of credit are not governed by any legislation.

The legal principles governing the South African law relating to letters of credit and demand guarantees are to be found in a number of sources.¹⁷ South Africa does not have any enacted legislation that specifically deals with letters of credit or demand guarantees. Therefore, disputes must predominantly be addressed under explicit contractual provisions, unwritten rules, common-law principles of contract and commercial law and case law.¹⁸ However, because of the highly international nature of documentary credits, certain individual countries have introduced special legislation governing these instruments. Where there is any legislation in this regard in a country, with the exception of art 5 of the Uniform Commercial Code (UCC) in the United States of America,¹⁹ 'it tends to consist of only a few provisions often of a general nature.'²⁰

The law of documentary credits has developed mainly through practice and customary usage.²¹ Therefore, many of its operative rules, irrespective of geography or legal system, have emerged from the customs of bankers dealing with importers and exporters, and with shipping and insurance companies. Since 1933,²² the International Chamber of Commerce (ICC)²³ has drafted and issued Uniform Customs and Practice

Confirming Banks (published LLD, University of Stellenbosch 1996) (1997); AN Oelofse, *The Law of Documentary Letters of Credit in Comparative Perspective* (Interlegal 1997).

14 Bertrams (n 3) 3; Michelle Kelly-Louw, 'Limiting Exceptions to the Autonomy Principle of Demand Guarantees and Letters of Credit' in Coenraad Visser and Jopie T Pretorius (eds), *Essays in Honour of Frans Malan* (2014) 197–199.

15 Kelly-Louw (n 14) 199.

16 JP van Niekerk and WG Schulze, *The South African Law of International Trade: Selected Topics* (4th edn, SAGA 2016) 248.

17 For a discussion, see Van Niekerk and Schulze (n 16) 248–256; Michelle Kelly-Louw, 'The Law Applicable to Demand Guarantees and Standby Letters of Credit' (2010) 24(2) *Speculum Juris* 1; Kelly-Louw LLD (n 1) ch 3.

18 Filip De Ly, 'The UN Convention on Independent Guarantees and Stand-by Letters of Credit' (Fall 1999) *International Lawyer* 831 at 833.

19 In the United States art 5 of the UCC specifically governs commercial letters of credit, and disputes relating to their standby letters of credit are also decided under art 5 of the UCC (Xiang Gao, *The Fraud Rule in the Law of Letters of Credit: A Comparative Study* (Kluwer 2002) 15).

20 Gao (n 19) 15.

21 Van Niekerk and Schulze (n 16) 250–252.

22 *ICC Publication No 82*, Paris (1933).

23 For more on the ICC see <<http://www.iccwbo.org>> (last accessed 15 May 2020).

for Documentary Credits (UCP). The UCP is a set of rules issued and regularly revised by the ICC (last revised in 2007 (UCP 600²⁴)) that is available for parties to incorporate into their letters of credit.²⁵ In practice, many letters of credit (including those issued by South African banks) are issued subject to the UCP.²⁶

In addition to these rules, the ICC has also introduced uniform rules that can apply to demand guarantees and standby letters of credit should parties decide to incorporate it, namely the 1978 Uniform Rules for Contract Guarantees (URCG),²⁷ the 1992 Uniform Rules for Demand Guarantees (URDG 458)²⁸, the new 2010 Revision of the ICC Uniform Rules for Demand Guarantees (URDG 758)²⁹ which came into effect on 1 July 2010, and the International Standby Practices (ISP98).³⁰ In addition to these rules, the United Nations Commission on International Trade Law (UNCITRAL) has adopted a universal legal framework for demand guarantees and standby letters of credit called the ‘United Nations Convention on Independent Guarantees and Stand-by Letters of Credit (1996)’ (UNCITRAL Convention).³¹

General sources of the law of commercial and standby letters of credit and demand guarantees, because of their highly international nature, are also often international banking practice and usages in international trade.³² These are often set out in the abovementioned rules issued by the ICC.

In certain jurisdictions—for example, South Africa, England and the United States of America—court decisions have constituted an important part of the law of commercial and standby letters of credit and demand guarantees. In common-law countries the law on demand guarantees has developed especially in case law. Owing to the international nature of most commercial and standby letters of credit and demand guarantees, the decisions of courts from other jurisdictions, especially English courts, have played, and will continue to play, an important role in the judicial interpretation of these instruments

24 *ICC Publication No 600 (2006) (UCP 600)*.

25 Lars Gorton, ‘Draft UNCITRAL Convention on Independent Guarantees’ (May 1997) *Journal of Business Law* 240 at 242.

26 Although the UCP apply to commercial and standby letters of credit, by implication they also apply to demand guarantees (see Goode (n 7) 729 fn 20; and Goode (n 1) 8).

27 *ICC Publication No 325 (1978)*.

28 *ICC Publication No 458 (April 1992)*.

29 *ICC Publication No 758 (2010)*. The 2010 URDG were provided with an ICC commentary prepared by Georges Affaki and Roy Goode (see Affaki and Goode *Guide to ICC Uniform Rules for Demand Guarantees 758 (2011) ICC Publication No 702E*).

30 *ICC Publication No 590 (1998)*.

31 Gao (n 19) 15. Neither South Africa nor England has acceded to the UNCITRAL Convention.

32 Peter Ellinger, ‘The Uniform Customs and Practice for Documentary Credits (UCP): Their Development and the Current Revisions’ (2007) *Lloyd’s Maritime and Commercial Law Quarterly* 152.

issued by South African banks, insurers and other financial institutions.³³ Legal writings are also regarded as supplementary to the law of demand guarantees, standby and commercial letters of credit.³⁴

The independence principle of demand guarantees (and letters of credit) is not unconditional and over time some exceptions to this principle have come to be accepted and recognised both in South Africa and internationally.³⁵ This means that, in certain circumstances, the independence principle of demand guarantees may be disregarded by the guarantor and courts and consideration may be given to the terms and conditions of the underlying contract.³⁶ South African courts accept established fraud as a valid exception to the independence principle.³⁷ English law similarly acknowledges established fraud as a valid reason (ground) for a guarantor to refuse to pay in terms of a demand guarantee.³⁸ Internationally proven fraud (and forgery) is accepted as a valid

33 Van Niekerk and Schulze (n 16) 250.

34 Ellinger (n 32) 152.

35 Kelly-Louw LLD (n 1) 61.

36 Kelly-Louw (n 2) 48.

37 In *Phillips v Standard Bank of South Africa Ltd* 1985 (3) SA 301 (W), the judgment merely reflected a cautious appreciation of this exception. The first clear endorsement of the fraud exception in South Africa emerged only in the letter-of-credit case *Loomcraft* (n 10), in which Scott AJA held that upon the submission of conforming documents ‘the bank will escape liability only upon fraud on the part of the beneficiary’ (at 815J). For this view, Scott AJA relied on Lord Diplock’s judgment in *United City Merchants (Investments) Ltd and Glass Fibres and Equipments Ltd v Royal Bank of Canada (incorporated in Canada), Vitrorefuerzos SA and Banco Continental SA* [1983] AC 168 (HL) ([1982] 2 Lloyd’s Rep 1 (HL)), where it was held that ‘there is one established exception: that is, where the seller, for the purpose of drawing on the credit, fraudulently presents to the ... bank documents that contain, expressly or by implication, material representations of fact that to his (the seller’s) knowledge are untrue’ (at 183G). For more cases, see *Lombard Insurance v Landmark* (n 8); *Casey & Another v Firstrand Bank Ltd* 2014 (2) SA 374 (SCA) paras 5, 6 and 16; *Coface South Africa v East London* (n 8) paras 10 and 11; *Firstrand Bank Ltd v Brera* (n 8) para 11; *Guardrisk v Kentz* (n 8) paras 15 and 17; *Denel v Absa Bank Ltd* (n 8) paras 27, 30 and 50; *Petric v Toasty Trading* (n 8) para 28; *Group Five Construction (Pty) Limited v Member of the Executive Council for Public Transport Roads and Works Gauteng* 2015 (5) SA 26 (GJ); *Casey v First National Bank* (n 8) paras 16, 17 and 20; *Eskom v Hitachi* (n 8) para 14; *Basil Read v Nedbank* (n 8) paras 31–34; *Group Five v Cenpower* (n 8). For a discussion of the development of fraud as an exception under South African law, see Kelly-Louw (n 14) 197–218; Kelly-Louw LLD (n 1) ch 5 paras 5.1–5.3 and 5.6; Sharrock (n 1) 422–430 and 449–451; Van Niekerk and Schulze (n 16) 291–298; Karl Marxen, *Demand Guarantees in the Construction Industry: A Comparative Legal Study of their Use and Abuse from a South African, English and German Perspective* (published LLD thesis, University of Johannesburg 2018) paras 5.2.4–5.2.6. For a discussion of the English law, see Kelly-Louw LLD (n 1) ch 5 para 5.4; Malek and Quest (n 7) 18 para 1.35 and ch 9; Marxen (n 37) paras 5.2.1–5.2.4; Deborah Horowitz, *Letters of Credit and Demand Guarantees: Defences to Payment* (Oxford University Press 2010) 24 para 2.14ff.

38 Malek and Quest (n 7) 18 para 1.35 and ch 9.

exception,³⁹ but there is no international consensus on the acceptance of any other exceptions: the existence of other exceptions, besides fraud, differs from jurisdiction to jurisdiction.⁴⁰

It is not certain in all jurisdictions whether it is an exception to the independence principle if the demand guarantee itself and/or its underlying contract is contrary to the law (ie, illegal),⁴¹ good morals or public policy.⁴² To determine whether these grounds will constitute an exception to the independence principle of the demand guarantee, it is important to differentiate clearly between cases where it is the demand guarantee itself that is illegal or against good morals or public policy, on the one hand, and cases where

39 Nelson Enonchong, 'The Autonomy Principle of Letters of Credit: An Illegality Exception?' (2006) *Lloyd's Maritime and Commercial Law Quarterly* 404 at 405.

40 For more on the acceptance of other potential exceptions in different jurisdictions, see Michelle Kelly-Louw, 'Illegality as an Exception to the Autonomy Principle of Bank Demand Guarantees' (2009) *CILSA* 339 fn 2 at 340–341 and 351; Van Niekerk and Schulze (n 16) 291–298; Sharrock (n 1) 428–430 and 451–455; Kelly-Louw (n 14) 214–218; Horowitz (n 37).

41 The URDG 758 offer some direction dealing with the situation where it becomes illegal under the law of the place for payment to make payment in the currency specified in the guarantee (see art 21(b)(ii) of the URDG 758; and for more on this article, see Affaki and Goode (n 29) 243 para 5.9, 333 para 21.7 373 para 26.4 and paras 416, 439, 441). The URDG 458 also offer some guidance on what happens to the obligation of the guarantor (issuer) of the demand guarantee if the payment is illegal in certain circumstances (see, eg, art 7(a) of the URDG 458; and for more on this article, see Kelly-Louw (n 40) fn 3 at 341).

42 Kelly-Louw (n 40) 340–341. There is no uniformity in the different jurisdictions regarding the acceptance of illegality in the underlying contract as an exception: Nelson Enonchong, *The Independence Principle of Letters of Credit and Demand Guarantees* (Oxford University Press 2011) 203 para 8.48). Generally the American courts have not permitted the illegality in an underlying contract to influence the beneficiary's right to claim payment in terms of the commercial and standby letter of credit (for a discussion of how the American law deals with the illegality exception, see Kelly-Louw LLD (n 1) ch 6 para 6.3.2). The American Revised UCC art 5 also does not cater for the acceptance of an illegality exception to the independence principle of letters of credit. America thus seemingly rejects the illegality exception (Enonchong (n 42) paras 8.48–8.49 at 203–204; and see also James Barnes, "'Illegality' as excusing Dishonour of l/c Obligations' (January–March 2005) 11 *ICC's DCInsight* 7). In contrast, civil law recognises illegality as an exception to the independence principle. For example, in German law abusive demands on independent guarantees are dealt with in accordance with the doctrine of abuse of right (*Rechtsmissbrauch*) which is based on notions of good faith and fair dealings arising from para 242 of the German Civil Code. In order to successfully rely on this defence, however, a convincing case and clear evidence of illegality must be established. See, eg, BGH 1996 *WM* 995 996 and BGH 1994 *NJW* 390 of which cases confirm that the BGH appreciates that an underlying contract which is void due to illegality or contravenes international exchange control regulations may serve as a valid defence to payment under a demand guarantee only if clear evidence of the illegality is immediately available. For more on the German law see Marxen (n 37) 163–167.

it is the underlying contract that is illegal or against the good morals or public policy, on the other.⁴³

It is unclear whether the South African courts accept any other exceptions, besides established fraud.⁴⁴ It is questionable under the South African law whether illegality in the underlying contract of a demand guarantee constitutes a valid exception to its independence principle.⁴⁵ In the past, there were no South African court cases where illegality in the underlying contract was accepted, or even considered, as a possible exception to the independence principle. A few South African commentators favoured the acceptance of such illegality as an exception.⁴⁶ However, in a recent South African case, *Mattress House (Proprietary) Ltd v Investec Property Fund Ltd*,⁴⁷ we now find the first evidence of a South African High Court's willingness to accept the possibility of illegality in the underlying contract as constituting a valid exception. The English courts indicated that they were open to accepting illegality in the underlying contract as an exception to the principle of independence of demand guarantees, but they did not develop the exact parameters of such an exception.⁴⁸

Our focus here is to discuss whether illegality in the underlying contract of a demand guarantee constitutes a valid exception to the independence principle of demand guarantees under South African and English law respectively. We therefore discuss fully the *Mattress House* judgment, which provides general guidance on the possibility of accepting illegality in the underlying contract as a valid exception under South African law. As this article is devoted mainly to the illegality exception, we pay little attention to the fraud exception also raised in the *Mattress House* case. Furthermore, we discuss whether the English courts are still willing to accept illegality in the underlying

43 Enonchong (n 39) 406; Kelly-Louw (n 40) 341.

44 For a short period of time the South African Supreme Court of Appeal accepted, besides fraud by the beneficiary, another exception to the independence principle (see the majority judgment in *Dormell Properties v Renasa* (n 8); and for a discussion of this case, see Charl Hugo, 'Documentary Credits and Independent Guarantees' *ABLU* 2011 (a paper delivered at the 2011 Annual Banking Law Update held at the Indaba Hotel, Johannesburg on 4 May 2011) 116 at 123–126; Kelly-Louw (n 14) 197–218). The Supreme Court of Appeal later overruled its earlier judgment and again confirmed that only fraud by the beneficiary would constitute a valid exception (see *Coface South Africa v East London* (n 8); and for a discussion, see Kelly-Louw (n 14) at 197–218). Some courts seemingly accept other grounds: see, for example, *Hollard Insurance Co Ltd v Jeany Industrial Holdings (Pty) Ltd* (2015/17231) [2016] ZAGPJHC 175 (24 June 2016) at paras 27 and 28; *Sulzer Pumps (South Africa) (Proprietary) Limited v Covec-MC Joint Venture* (1672/2013) (2014) ZAGPPHC 695 (2 September 2014).

45 For a detailed discussion, see Kelly-Louw (n 40).

46 See Kelly-Louw (n 40), in particular 380–381 and 385.

47 (2017/36270) [2017] ZAGPHC 298 (13 Oct 2017).

48 For detailed discussions, see Malek and Quest (n 7) 18 para 1.35, para 8.17 and ch 13 at 412–429; Horowitz (n 37) ch 7.

contract as being a valid exception to the independence principle of demand guarantees. We do not, however, discuss in any detail instances where it is the demand guarantee itself that is contrary to the law, good morals or public policy, as those have already been discussed sufficiently elsewhere.⁴⁹ Regarding this final point, we merely summarise the prevailing position for the sake of completeness.

Illegality of the Demand Guarantee Itself

It is established law in South Africa and England that a contract that is contrary to the law, public policy or good morals is illegal and therefore void in terms of the general principles of the law of contract in each individual jurisdiction.⁵⁰ According to the rule *ex turpi causa non oritur actio*—an illegal contract does not give rise to an action and a court must refuse to give effect to it (in short, no action arises from a shameful cause).⁵¹ By implication, it follows that if it is the demand guarantee itself that is contrary to the law, public policy or good morals (ie, the law of the country that is applicable to the guarantee, or the law of the country where the guarantee is to be executed (performed)), it will not be enforceable.⁵² A demand guarantee may be rendered illegal by law in the place where it is to be paid, prohibiting payment under the guarantee.⁵³ Such illegality can be an existing or a supervening event and in either event the guarantee will be rendered null and void.⁵⁴ A supervening statutory prohibition often happens where a government decides to impose trade and financial sanctions⁵⁵ against a specific

49 Enonchong (n 39) 406. For a discussion of how the English law, American law and South African law deal or will probably deal with instances where it is the guarantee itself that is contrary to the law, good morals or public policy, see Kelly-Louw (n 40) 341, 352–354, 370–371 and 376–377.

50 Kelly-Louw (n 40) 352–354, 376–377 and 383; Van Niekerk and Schulze (n 16) 291; and Enonchong (n 42) 186 para 8.03. For a discussion of when a contract will be unlawful or against the good morals or public policy under South African law see Heinrich Schulze and others, *General Principles of Commercial Law* (9th edn, Juta 2019) 87–95; Graham Bradfield, *Christie's Law of Contracts in South Africa* (6th edn, LexisNexis 2016) ch 10; Alistair Kerr, *The Principles of the Law of Contract* (6th edn, LexisNexis 2002) ch 8. For a full discussion of the law of contract under English Law, see Ewan McKendrick, *Contract Law* (13th edn, Red Globe Press 2019).

51 Schulze (n 50) 94; Kelly-Louw (n 40) 376–377; Van Niekerk and Schulze (n 16) 291; Enonchong (n 42) 186 para 8.02.

52 Kelly-Louw (n 40) 352 and 383; Van Niekerk and Schulze (n 16) 291.

53 Article 21(b)(ii) of the URDG 758 and Art 7(a) of the URDG 458 offer some direction dealing with these situations—see (n 41).

54 Chuah (n 10) 598 para 11-078.

55 A trend has emerged for banks to insert sanctions clauses in demand guarantees and letters of credit (see, eg, the ICC *Guidance Paper on the Use of Sanctions Clauses in Trade Finance-related Instruments subject to ICC Rules*, Document 470/1238 <<https://cdn.iccwbo.org/content/uploads/sites/3/2014/08/Guidance-Paper-on-The-Use-Of-Sanctions-Clauses-In-Trade-Finance-Related-Instruments-Subject-To-ICC-Rules.pdf>> accessed 23 June 2020).

country.⁵⁶ Such a sanction could prohibit payment for a certain period of time, but could even continue after the sanctions have been lifted.⁵⁷ A demand guarantee itself may also be illegal where, for example, the issuing of the guarantee is forbidden. This will be the situation where it is against specific legislation to issue a demand guarantee in favour of beneficiaries from specific countries (eg, where the beneficiary is a citizen of a country considered to be a foreign enemy of the state or where the outbreak of war makes the beneficiary such a foreign enemy).⁵⁸ Where the demand guarantee is itself illegal but the underlying contract is legal, the principle of independence does not come into play and no problem arises as a result of that principle.⁵⁹

Furthermore, if both the demand guarantee and the underlying contract are illegal for the same reason (eg, under the same prohibition), the illegality of the demand guarantee is not influenced by the independence principle, because the guarantee is illegal itself instead of through illegality in the underlying contract.⁶⁰ It has also been argued correctly that South African courts are unlikely to arrive at a different conclusion regarding instances where the guarantees themselves are illegal.⁶¹ Although no South African court has dealt with such matters or expressed opinions on them, support for some of the aforementioned views regarding guarantees that are themselves illegal may be found in the *Mattress House* judgment⁶² (discussed below).

However, what is less certain is whether South African courts will have a similar view in the case where the demand guarantee itself is contrary to the law, public policy or good morals of a foreign jurisdiction (country).⁶³ It is true that it should not make any difference whether the demand guarantee is illegal in terms of South African law or the law of another jurisdiction.⁶⁴ However, on condition that it can be confirmed to be contrary to the law that is applicable to the demand guarantee or the law of the place of execution (performance) of the guarantee, the South African courts should not enforce such guarantees.⁶⁵

56 Enonchong (n 42) 186 para 8.04.

57 Enonchong (n 42) 187 para 8.04.

58 Kelly-Louw (n 40) 352.

59 Kelly-Louw (n 40) 352–354, 376–377 and 383; Enonchong (n 42) 186 para 8.03.

60 See Kelly-Louw (n 40) 353–354, in particular notes 49–50. See also *United City Merchants v Royal Bank of Canada* (n 37); *Wahda Bank v Arab Bank Plc* (1992) 2 Bank LR 233.

61 Kelly-Louw (n 40) 377.

62 *Mattress House* (n 47) para 26 (should be numbered para 30) and para 30 (should be numbered para 34).

63 Kelly-Louw (n 40) 377.

64 *ibid.*

65 Kelly-Louw (n 40) 353 and 377.

Illegality of the Underlying Contract

General

A problematic situation arises where it is not the demand guarantee itself that is illegal, contrary to public policy or good morals, but rather the underlying contract that is (eg, the sale of illegal ammunition to enable drug trafficking or money laundering). It is sometimes reasoned that because a demand guarantee is independent of, and distinct from, the underlying contract, the illegality (or its being contrary to public policy or good morals) of the underlying contract is unrelated to the enforceability of the guarantee.⁶⁶ However, if one were to accept this reasoning, it would mean that the guarantor would be permitted to ignore the illegality of the underlying contract and as a result would be supporting and condoning the illegal objectives of the parties to the underlying contract.⁶⁷

Van Niekerk and Schulze correctly question whether the guarantor, for instance a bank, should, as a matter of principle, even be involved in a dispute relating to the illegal conduct or real motives of the parties to the underlying contract.⁶⁸ They argue that to expect the guarantor to investigate the legality of the underlying contract would not only thwart the independence of the demand guarantee, but also place a burdensome duty on the guarantor to investigate the intentions and goals of the parties to the underlying contract.⁶⁹ However, they also counter their own argument by reasoning that it is also objectionable to permit a party to an illegal contract to enforce it simply because the guarantor is not allowed to investigate the legality of the underlying contract.⁷⁰

The guarantor's primary obligation is to pay against stipulated documents that are presented within the required period and in accordance with the other conditions of the demand guarantee.⁷¹ Van Niekerk and Schulze agree that there is no general duty on a guarantor (a bank) to investigate the validity of the underlying contract. Instead, they propose that if the guarantor has actual knowledge of the illegality of the underlying contract—for example, where it is evident from the information supplied by the applicant on the application form for the demand guarantee that certain foreign-exchange regulations will be transgressed by the guarantor if it complies with its payment instruction under the guarantee—it should decline to honour it.⁷² Equally, if the guarantor may obtain knowledge of the illegality of the transaction by using reasonable care, it should similarly be under a duty not to honour the demand guarantee.

66 Van Niekerk and Schulze (n 16) 291; Kelly-Louw (n 40) 354 and 378.

67 Van Niekerk and Schulze (n 16) 291.

68 *ibid.*

69 *ibid.*

70 *ibid.*

71 Kelly-Louw THRHR (n 10) 159 and 164.

72 Van Niekerk and Schulze (n 16) 291.

However, where the guarantor is neither really aware of the illegality of the underlying contract nor able to become aware by exercising reasonable care, its payment under the demand guarantee cannot be questioned.⁷³

Unfortunately, the English cases and writers are vague on what the duties of the guarantor are in relation to illegality in the underlying contract.⁷⁴ Enonchong submits that no additional duties are placed on guarantors in such a case. He confirms that the duty of a guarantor is only to examine a presentation in order to determine, on the basis of the documents only, whether or not the documents appear on their face to constitute a complying presentation. If this examination does not disclose the illegality, the guarantor is forced to pay in terms of the demand guarantee. However, if the guarantor has clear evidence of illegality, the guarantor is not necessarily obliged to carry out investigations to discover whether there is illegality in the underlying contract, and may refuse to pay based on the evidence it has.⁷⁵

English Law

Initially under English law there was some uncertainty⁷⁶ whether illegality only in the underlying contract was also a distinct exception to the independence principle.⁷⁷ For instance, in *Group Josi Re v Walbrook Insurance Co Ltd & Others*,⁷⁸ a case involving letters of credit, the Court of Appeal, *per* Staughton LJ, merely said *obiter* that illegality in the underlying contract (in this case, reinsurance contracts) could provide a defence to an issuer to refuse to make payment ('separate ground for non-payment') under a letter of credit under English Law.⁷⁹ Lord Justice Staughton set out *obiter* the

73 *ibid.*

74 Kelly-Louw (n 40) 378. Chuah correctly stresses that it is important to ask to whether and to what extent a bank is obliged to make enquiries whether payment under a letter of credit/demand guarantee will be intended to serve an illegal purpose, but provides no clear answer to this question (Chuah (n 10) 599 para 11-081).

75 Enonchong (n 42) 189–190 para 8.12.

76 The discussion of the Court of Appeal in *Group Josi Re v Walbrook Insurance Co Ltd & Others* [1996] 1 Lloyd's Rep 345 (CA) ([1996] 1 WLR 1152 (CA); [1996] 1 All ER 791 (CA)) 362 and 368 was indecisive. See also the decision of the court *a quo* in *Deutsche Rückversicherung AG v Walbrook Insurance Co Ltd & Others; Group Josi Re (formerly known as Group Josi Reassurance SA) v Walbrook Insurance Co Ltd & Others* [1995] 1 WLR 1017 (QBD) ([1994] 4 All ER 181 (QBD)) 1027.

77 Enonchong (n 39) 409; see also Enonchong (n 42) ch 8.

78 [1996] 1 Lloyd's Rep 345 (CA) ([1996] 1 WLR 1152; and [1996] 1 All ER 791 (CA)); see also Malek and Quest (n 7) para 13.107; Enonchong (n 42) 190–191; Kelly-Louw (n 40) 356–358.

79 [1996] 1 Lloyd's Rep 345 (CA) at 362. Lord Justice Staughton said (362):

'there must be cases when illegality can affect a letter of credit. Take for example a contract for the sale of arms to Iraq, at a time when such a sale is illegal. The contract provides for the opening of a letter of credit, to operate on presentation of a bill of lading for 1000 kalashnikov rifles ... I

consequences of illegality of the underlying reinsurance contracts on the letters of credit linked to these contracts.⁸⁰

if the reinsurance [underlying] contracts are illegal, and if the letters of credit are being used as a means of paying sums due under those contracts, and if all that is clearly established, would the Court restrain the bank from making payment or the beneficiary from demanding it? In my judgment the Court would do so. That would not be because the letter of credit contracts were themselves illegal, but because they were being used to carry out an illegal transaction.

Thus, before illegality could operate as a ground for restraining payment by the issuer or as a defence, it, akin to fraud, had to be clearly established and known to the issuer.⁸¹ Lord Justice Staughton clearly opined that if letters of credit were ‘being used to carry out an illegal transaction’ payment in terms of them should be prevented.⁸² Despite Lord Justice Staughton’s remarks concerning illegality, it was not successfully proven in this case. The other Lord Justices also did not necessarily agree with Lord Justice Staughton’s views on the illegality exception.

As the court did not expressly conclude whether illegality was a distinct and separate exception, the judgment offers inconclusive authority on the matter.⁸³ Nonetheless, this judgment is still important for three reasons. First, it reflects an appreciation of the independence of the reinsurance contracts and the letters of credit. Secondly, it highlights the place and importance of illegality as a potential exception to this independence. Thirdly, it emphasises that the illegality of the underlying contract must affect the guarantee to be able to constitute a defence for non-payment.

Later on, the English High Courts⁸⁴ indicated more clearly their willingness to recognise such illegality as an exception, in appropriate cases.⁸⁵ However, they neglected to specify precisely to what extent (or scope) illegality in the underlying contract could

do not suppose that a Court would give judgment for the beneficiary against the bank in such a case.’

80 [1996] 1 Lloyd’s Rep 345 (CA) 362–363.

81 At 362.

82 At 363.

83 Enonchong (n 42) paras 8.16–8.17 at 191; Kelly-Louw (n 40) 358.

84 See, for example, *Mahonia Ltd v West LB AG* [2004] EWHC 1938 (Comm) (trail); and *Mahonia Ltd v JP Morgan Chase Bank & Another* [2003] 2 Lloyd’s Rep 911 (QB (Com Ct)) (summary judgment application). For a discussion, see Enonchong (n 42) 191–192.

85 Enonchong (n 39) 409.

provide the foundation for a defence to a claim under a letter of credit and a demand guarantee.⁸⁶

In *Mahonia Ltd v JP Morgan Chase Bank*,⁸⁷ the court had to decide during a summary judgment application whether illegality in the underlying contract could be a defence to a bank sued under a letter of credit. Colman J was called upon to deal with this matter involving a standby letter of credit⁸⁸ which secured alleged illegal swap transactions (underlying contract (transaction)) presumably in violation of American security laws and accounting regulations. The matter also involved the infamous Enron. The beneficiary (Mahonia) made a complying demand in terms of the standby letter of credit, but the issuing bank refused to pay. It was *inter alia* argued that the purpose behind the underlying contract was illegal under American law and therefore the standby letter of credit was also illegal either directly or through *taint* and for that reason unenforceable as a matter of English public policy.⁸⁹ The beneficiary applied for the illegality defence to be struck out and for summary judgment against the issuing bank. Against this background, Colman J commented strongly in favour of recognising illegality as an exception to the independence principle:⁹⁰

If a beneficiary should as a matter of public policy (*ex turpi causa*) be precluded from utilizing a letter of credit to benefit from his own fraud, it is hard to see why he should be permitted to use the courts to enforce part of an underlying transaction which would have been unenforceable on grounds of its illegality if no letter of credit had been involved, however serious the material illegality involved. To prevent him doing so in an appropriate serious case such as one involving international crime could hardly be seen as a threat to the lifeblood of international commerce.

It was argued that the underlying contract was seemingly illegal under American law but not under English law and therefore the court had to decide whether the English courts would refuse to enforce a contract where the purpose was to commit an act illegal in a foreign country.⁹¹ In the end, Colman J found that it was irrelevant that the underlying contract was unlawful, not under English law but under the law of a foreign

86 Enonchong (n 39) 405; Malek and Quest (n 7) para 13.114. For a discussion of the English law in this regard, see Kelly-Louw (n 40) 354–370.

87 [2003] 2 Lloyd's Rep 911 (QB (Com Ct)); and for a discussion see Kelly-Louw (n 40) 358–370; PS Turner, 'Mahonia Ltd v JP Morgan Chase Bank: The Enron l/c and the Issuing Bank's Defence of Illegality' (2006) 8 Journal of Payment Systems Law 733; Jason Chuah, 'Documentary Credits and Illegality in the Underlying Transaction' (2003) 9 Journal of International Maritime Law 518; Malek and Quest (n 7) paras 13.108–13.110.

88 The standby letter of credit has a very different historical development than the demand guarantee: see Kelly-Louw LLD (n 1).

89 [2003] 2 Lloyd's Rep 911 QB (Com Ct) 913–914.

90 [2003] 2 Lloyd's Rep 911 QB (Com Ct) 927 para 68.

91 Paragraphs 13 and 14 at 916.

friendly state.⁹² All that was required for it was just that it had to be contrary to public policy to permit the claimant to enforce a contract that had been concluded for a foreign illegal purpose.⁹³

Based on the presumed facts in this case, Colman J held that it was strongly debatable whether the letter of credit should be paid and said:⁹⁴

[T]he conclusion as to whether enforcement is permissible at least arguably depends on the gravity of the illegality alleged. Although on the pleaded case that appears to be, the uncertainty of this area of law is such that this is an issue which ought to considerable be determined by reference to the evidence before the court at trial and not merely on assumptions derived from the pleaded defence. Moreover, I have also concluded, ... that the fact that the bank did not have clear evidence of such illegality at the date when payment had to be made would not prevent it having a good defence on that basis if such clear evidence were to hand when the Court was called upon to decide the issue. For this purpose I proceed on the basis that it now has sufficiently clear evidence as expressed in the pleading.

Therefore, the illegality of the underlying contract could taint the standby letter of credit and in that manner render the letter of credit unenforceable. Accordingly, Colman J dismissed the beneficiary's application that the defence be struck out.⁹⁵ Furthermore, the decision whether enforcement was allowed essentially depended on the seriousness of the alleged illegality and due to the uncertainty of this area of the law this was an issue which the trial court ought to decide upon based on the evidence brought before it.⁹⁶

As a result, the case proceeded to trial in *Mahonia Ltd v West LB AG*⁹⁷ and served before Cooke J. He considered the merits of the case and concluded that there was no breach of the American accounting standards and law and, therefore, the underlying contract was not illegal and accordingly the beneficiary succeeded with its claim in terms of the letter of credit.⁹⁸ In light of Cooke J's conclusion, he was of the view that it was unnecessary to deal with the question whether the illegality of the underlying contract constituted a valid defence to payment under letters of credit. He did, however, consider what the hypothetical case would have been if the parties had been successful in proving that the underlying contract was illegal. In such a hypothetical instance, he said, the letter of credit would directly have been tied to the illegality of the underlying contract.

92 Paragraph 28 at 919.

93 Paragraphs 29–31 at 919.

94 Paragraph 69 at 927–928.

95 *ibid.*

96 [2003] 2 Lloyd's Rep 911 QB (Com Ct) 928 para 69.

97 [2004] EWHC 1938 (Comm).

98 [2004] EWHC 1938 (Comm) para 423.

Even though it was unnecessary for Cooke J to decide what would have been the effect of illegality in the underlying contract on the enforceability of the letter of credit, he nevertheless continued, deliberated this issue and arrived at the same conclusion as Colman J, that is, that the independence principle of a letter of credit did not prohibit it from being tainted by the illegality of the underlying contract. It was, therefore, possible for illegality in the underlying contract to constitute a defence to the enforcement of a standby letter of credit. Cooke J also emphasised that whether enforcement would be permitted under the letter of credit rested on the *gravity* of the illegality claimed (eg, illegal arms sale or sale of heroin). Although at trial Cooke J did not accept the issuer's defence which Colman J had declined to strike out at the interlocutory hearing, he would have accepted the issuer's defence if certain facts could have been proved.

The *Group Josi* case to some extent, and the *Mahonia* cases particularly, did, in principle, accept the illegality of the underlying contract as a valid defence to payment under letters of credit (and by implication also demand guarantees), especially where the beneficiary was complicit.⁹⁹ Accordingly, English courts are likely, on considerations of public policy, to deny a claim under a demand guarantee if the underlying transaction is illegal. Put differently, conflicting policy considerations relating to the independent nature of demand guarantees and a financial institution's refusal to allow a beneficiary to benefit from an underlying transaction that is illegal may be resolved, in our view, on the basis of public policy considerations.

In *Oliver v Dubai Bank of Kenya*¹⁰⁰ the court simply stated that, apart from fraud, illegality on the part of the beneficiary could possibly be an exception, but the court did not elaborate further on such a possibility. To our knowledge, the English Court of Appeal and the House of Lords have not yet specifically accepted the illegality of the underlying contract as constituting an exception to the independence principle of demand guarantees or letters of credit.¹⁰¹ As many of the statements made by the courts in the *Mahonia* cases, particularly by Cooke J, regarding the acceptance of the illegality exception to the independence principle were merely made *obiter*, the illegality exception remains fairly controversial under English law and its ambit remains unsettled.¹⁰² For instance, the following issues remain speculative: the precise application of the illegality exception; the specific types (degree) of illegality that would be considered sufficient to constitute an exception (ie, 'illegality' and 'taint' as concepts);¹⁰³ the difficulty in determining whether a specific illegality is serious or

99 Malek and Quest (n 7) paras 13-106 and 3.114; Enonchong (n 42) 192-193 para 8.21.

100 [2007] EWHC 2165 (Comm) para 12.

101 Kelly-Louw (n 40) 355; and Enonchong (n 42) 190 para 8.14.

102 Michael Brindle and Raymond Cox (eds), *Law of Bank Payments* (3rd edn, Sweet & Maxwell 2004) para 8-037; Malek and Quest (n 7) para 3.114; Hewetson and Mitchell (n 1) 160; Enonchong (n 39) 405 and 410; Enonchong (n 42) 192-193 para 8.21; Kelly-Louw (n 40) 365.

103 Chuah (n 10) 599 para 11-080.

trivial;¹⁰⁴ what state of mind the beneficiary and the issuer must be in at the time of presentation for payment (ie, does it have knowledge of the illegality or not and when the knowledge must be known);¹⁰⁵ and the precise standard of proof¹⁰⁶ that is required. The acceptance of an illegality in the underlying contract, ‘in an appropriate case’,¹⁰⁷ as an exception to the independence principle under English law is nevertheless generally well supported by many commentators.¹⁰⁸

From the English court cases and the scholarly writings on the possible acceptance of illegality as an exception to the independence principle it has been possible to identify certain minimum requirements that would, at least, have to be met before such an exception will be successful.¹⁰⁹ For instance:

- the alleged illegality must be clearly established (ie, clear evidence of illegality (standard of proof));¹¹⁰
- the illegality must be sufficiently serious (ie, gravity—preferably the illegality must include some form of a criminal element and not be illegal purely because of some technical or minor issue);¹¹¹

104 Enonchong (n 42) 188 para 8.27.

105 Hewetson and Mitchell (n 1) 160. Hewetson and Mitchell question whether knowledge of the illegality should be a requirement for the illegality exception to be successful (160).

106 Hewetson and Mitchell (n 1) 160.

107 Malek and Quest (n 7) para 3.114.

108 Enonchong (n 39) 410–413; Enonchong (n 42) 188–200; Michael Bridge, *Benjamin’s Sale of Goods* (9th edn, Sweet & Maxwell 2014) 2057 para 23-083; Horowitz (n 37) 224 para 7.80; Hewetson and Mitchell (n 1) 172–173; Malek and Quest (n 7) paras 13.106–3.114. Enonchong states that the illegality exception should be accepted on the basis of policy considerations, but the scope of this exception should be limited by a number of stringent factors he sets out; see Enonchong (n 42) 188 para 8.08; and see the listed factors discussed at paras 8.22–8.41.

109 For a detailed and motivated discussion, see Kelly-Louw (n 40) 364–369 and 383–386. See also Hewetson and Mitchell (n 1) 160; Enonchong (n 42) ch 8 at 193–200.

110 Hewetson and Mitchell (n 1) 160. The standard of proof is seemingly the same as for fraud (ie, clearly established) (Enonchong (n 42) 193 para 8.23).

111 The seriousness of the illegality is easy to establish in the extreme examples of illegality given by Staughton LJ and Colman J (eg, to enable the smuggling of drugs or arms), but where it involves other, less extreme forms of illegality (eg, failure to comply with a statute or regulation), it will often be difficult to determine exactly what the effect of the illegality in the underlying contract will be on the demand guarantee/letter of credit and if the illegality is of such a nature to sufficiently also ‘taint’ the guarantee/credit (see Malek and Quest (n 7) paras 13.111 and 13.113; Enonchong (n 42) 195 para 8.27).

- the beneficiary must have been involved (complicit) in or have knowledge of the illegality;¹¹² and
- the demand guarantee (or letter of credit) must be sufficiently connected to the illegality in the underlying contract (transaction).¹¹³

Where an application is made for an interim injunction (interdict), the claimant must, in addition, prove that the balance of convenience favours the issuing of the injunction.¹¹⁴ Although some minimum requirements of the illegality exception have been identified, exactly how they can be met or complied with remains unclear and fraught with difficulties. Useful guidance for applying the minimum requirements, particularly the standard of proof that is required or the beneficiary's involvement, may be found by having regard to the scope and application of the fraud exception.¹¹⁵ The defence of illegality under English law has not been fully developed or settled yet.¹¹⁶

South African Law

Before the *Mattress House* case,¹¹⁷ there were no other reported cases in South Africa where the courts had indicated their willingness to accept or even consider the possibility that illegality in the underlying contract could, in exceptional cases, constitute an exception to the independence principle of demand guarantees or letters of credit.¹¹⁸ The only support for accepting such illegality as an exception was found in the writings of a few South African academic writers.¹¹⁹

In the *Mattress House* case, Mattress House (Pty) Ltd trading as Mia Bella Interiors (Mattress House) entered into a lease agreement with Investec Property Fund Limited

112 It is true that 'testing the beneficiary's "guilty" knowledge might be difficult because illegality is a question of law and fact' (Malek and Quest (n 7) para 13.112; Enonchong (n 42) 196 paras 8.30–8.32).

113 Chuah states that in 'many cases of illegality, it is often virtually impossible to claim that the letter of credit is not significant to the underlying illegal transaction' (Chuah (n 10) 599 para 11-080). For a discussion of the difficulties in establishing an appropriate test by which the degree of connectivity may be measured, see also Enonchong (n 42) 188 para 8.09 and 197–200 paras 8.33–8.41.

114 Enonchong (n 42) 193.

115 Enonchong (n 42) 193–196.

116 Malek and Quest (n 7) paras 13.106 and 13.114; Hewetson and Mitchell (n 1) 599 para 11-080.

117 See (n 47) above.

118 Kelly-Louw (n 40) 379–380.

119 See Kelly-Louw (n 40) 380–381 and 385; Hugo (n 13) 316–317; and Sharrock (n 1) 429 and 451. Van Niekerk and Schulze simply allude to their acceptance of the illegality exception. They affirm that where the issuer/guarantor is aware of the illegality of the underlying contract (eg, foreign exchange regulations will be contravened if payment is made) the issuer/guarantor should refuse to honour the instrument (Van Niekerk and Schulze (n 16) 291 and 298).

(Investec) around 19 February 2015 relating to a certain premises situated at Building 1, Bryanston Boulevard, Bryanston (the premises).¹²⁰ Investec required of Mattress House (applicant of the demand guarantee) to procure the issuing of a demand guarantee in favour of Investec (beneficiary of the demand guarantee) to secure the due compliance of the terms and conditions of the lease (underlying contract). Mattress House accordingly applied successfully to Firststrand Bank Limited (the ‘guarantor’) for such a demand guarantee to be issued.¹²¹

The guarantee stipulated that Investec could call up the guarantee for payment ‘regardless of whether a *bona fide* and genuine dispute exists with [Mattress House] on monies owed or issues arising between [Investec] and [Mattress House].’¹²²

In terms of the lease agreement Mattress House was required to keep the demand guarantee in place for a period of three months after the expiry of the lease and/or after the discharge of all the obligations in terms of the lease.¹²³ Furthermore, the lease agreement had a site development plan attached to it in respect of the premises which bore a stamp of approval from the City of Johannesburg. The site development plan was dated 13 June 2005.¹²⁴

Mattress House later defaulted on the lease agreement and was in rental arrears.¹²⁵ As a result of its default, Investec caused action proceedings to be instituted in the Randburg Magistrates’ Court to recover the arrears and a summons was served on Mattress House on 7 September 2017.¹²⁶ Mattress House entered an appearance to defend the action.¹²⁷ The summons contained a rental interdict which was apparently also procured over the goods of Mattress House.¹²⁸ In addition, Investec made a demand for payment in terms of the demand guarantee.¹²⁹

Following the above events, Mattress House launched an urgent application for interim relief (interdict (injunction)) in which it sought to have the payment of the demand guarantee restrained pending the resolution of the dispute in the action proceedings. Mattress House retained possession and remained in occupation of the premises at the

120 *Mattress House* (n 47) para 5.

121 Paragraphs 9–10.

122 Paragraph 11.

123 Paragraph 10.

124 Paragraph 13.

125 Paragraph 7.

126 *ibid.*

127 *ibid.*

128 Paragraphs 1, 7 and 8.

129 Paragraph 1.

time of applying for the interdict. However, Mattress House was prevented from trading as a result of the rent interdict that Investec had apparently procured over its goods.¹³⁰

On 28 September 2017 the court *a quo, per* Opperman J, temporarily interdicted Investec from enforcing its rights in terms of the guarantee and from making any further demands in terms of it, until such time as the main application was to be finalised.¹³¹ The matter later served before Siwendu J for finalisation of the interim interdict.¹³² It is this judgment that is relevant for our purposes and which is discussed here.

During August 2012 and prior to the conclusion of the lease agreement, Investec subdivided the premises. On 22 August 2012, Investec lodged an application to the City of Johannesburg for the rezoning of the premises; this application required a site development plan, which was not attached. At the time of concluding the lease agreement, it is alleged that Mattress House was not aware that the premises required rezoning.¹³³ In November 2016, after entering into the lease agreement, Investec allegedly represented to Mattress House that the premises were zoned/approved by the City of Johannesburg on 12 June 2005 and that no further site development plan was required.¹³⁴ Mattress House, however, soon learnt that this was not true.¹³⁵ In this regard, the City of Johannesburg sent two letters, the first on 12 December 2016 and the second on 14 September 2017.¹³⁶ In the first correspondence, which was addressed to Investec, the City of Johannesburg stated as follows:

An inspection has revealed that the [premises] is being used in a manner which contravenes the Sandton Town Planning Scheme 1980.

The contravention in question is that: non-compliance with the approved amendment scheme 02-1271. Non-submission of site development plan Condition 1.

The city of Johannesburg is specifically compelled by ... of the town planning and townships ordinance 1986 to enforce its time planning scheme, ... Accordingly, I must ask you to discontinue permanently there and authorised used described above by not later than that of 31 January 2017 after which date a further inspection of your [premises] will be made.

Failure to comply with this notice Internet that an authorized use of your [premises] constitutes a criminal offence for which you are liable to prosecution in terms of ... the

130 Paragraphs 1 and 8.

131 Paragraphs 1–2.

132 *ibid.*

133 Paragraphs 12–13.

134 Paragraph 14.

135 Paragraph 15.

136 Paragraphs 16–17.

time planning in townships ordinance 1986. In addition, the council may institute super proceedings against anyone contravening or failing to comply with the scheme. The council will avail itself off one or both of these remitters should you fail to comply with this demand.¹³⁷

The second correspondence, addressed to Dewy Hertzberg Levy Inc (presumably Investec's legal representative), read as follows:¹³⁸

An application for the rezoning of the [premises] was submitted 22 August 2012. The application was to amend the zoning of the site in order to create is zoning that was consistent with what was actually on the site and to increase the FAR and coverage. This application was promulgated 26 March 2014.

One of the conditions is that a site development plan be submitted prior to the submission of building plans. There is no record that this was submitted. The onus is on the owner/Applicant to submit this for approval prior to submission of building plans. There is no record that a SDP was submitted on the [premises] and *therefore the building is illegal*. [Emphasis added.]

Apparently, the premises in respect of which the lease transaction arose did not comply with the applicable zoning laws because a required site development plan was not submitted to the City of Johannesburg with the rezoning application.¹³⁹

Mattress House argued that at the time it had concluded the lease agreement and secured the demand guarantee, it was unaware that the premises it would be leasing did not have the municipal planning permission authorisation for occupation. According to Mattress House, Investec had neglected to inform them of this. Mattress House further contended that if it had been aware of this, it would never have entered into the lease in the first place or have provided the accompanying demand guarantee.¹⁴⁰ Mattress House basically requested to have the funds secured by the demand guarantee preserved (in short, to confirm the interim interdict) pending the outcome of the action that had been instituted in the Randburg Magistrates' Court. Mattress House sought to challenge both the lease agreement (underlying contract) and the demand guarantee itself. To support such a contention, Mattress House argued that Investec had fraudulently withheld or misrepresented information which would show that the property required rezoning and the submission of a site development plan, and/or alternatively, that the illegality

137 Paragraph 16. The term 'Internet' used in the letter should presumably be replaced with the word 'implies'.

138 Paragraph 17.

139 Paragraphs 12–13 and 16–17.

140 Paragraph 12.

regarding Investec's failure to comply with the zoning laws affected the legality of the demand guarantee and the lease agreement.¹⁴¹

As a starting point, Siwendu J dealt with the four requirements of obtaining an interim interdict. She confirmed that Mattress House would have to show a *prima facie* right, a well-grounded apprehension of irreparable harm if the interim relief was denied, the passing of a balance of convenience test, and the absence of available alternative adequate remedies.¹⁴² Siwendu J stated that the crux of the matter was whether Mattress House could establish a *prima facie* right to restrain the payment of the demand guarantee pending the resolution of the dispute in the action proceedings in the Randburg Magistrates' Court. Doing so would depend on whether Mattress House could establish a clear and convincing case of fraud and/or illegality of the guarantee itself and/or the lease agreement (underlying contract). Mattress House would also have to prove that the balance of convenience favoured the granting of the interim relief.¹⁴³

The court's point of departure in reaching its finding was to set out the nature of the demand guarantee in question by confirming its independence from the underlying contract.¹⁴⁴ In this regard, the court referred to *Phillips v Standard Bank*¹⁴⁵ and *Lombard Insurance v Landmark*.¹⁴⁶ The independent nature of the demand guarantee was also acknowledged by the parties.¹⁴⁷ The court then turned to the legal position regarding the fraud exception to the independence principle and cited two decisions, namely the English case of *RD Hardbottle (Mercantile) Ltd v National Westminster Bank Ltd*¹⁴⁸ and the South African case of *Loomcraft*. In the *RD Hardbottle* case Kerr J held that '[e]xcept possibly in clear cases of fraud of which the banks have notice, the courts will leave the merchants to settle their disputes under the contracts by litigation or arbitration available to them or stipulated in the contracts.'¹⁴⁹ In the same vein, in the *Loomcraft* case,¹⁵⁰ the principle that emerged was that established fraud, on a balance of probabilities, provides an exceptional circumstance for a guarantor to escape the liability to pay.¹⁵¹

141 Paragraphs 14 and 19.

142 Paragraph 20.

143 Paragraphs 20–21.

144 Paragraphs 23–24.

145 *Phillips v Standard Bank* (n 37).

146 *Lombard Insurance v Landmark* (n 8).

147 *Mattress House* (n 47) para 11.

148 1977 (2) All ER 862 (QB).

149 At 870b.

150 See (n 10).

151 *Mattress House* (n 47) para 25.

Mattress House maintained that Investec deliberately and intentionally (fraudulently) withheld and misrepresented information which showed that the property required rezoning to permit the occupation and use by Mattress House and the submission of a site development plan.¹⁵² Investec denied that a further site development plan was required and argued that the premises had been approved by the municipality on 12 June 2005.¹⁵³ Investec further reasoned that Mattress House had not only failed to establish the fraud alleged, but that there was in fact no fraud to begin with.¹⁵⁴

The court held that in order for Mattress House to successfully raise the fraud exception it had to ‘clearly establish that [Investec] had a duty to disclose information in its possession’, the information was of a ‘material nature which would induce’ the lease agreement and Investec’s failure to disclose was intentional.¹⁵⁵ Without any hesitation, the court expressed its dissatisfaction with the establishment of fraud. It held that it was not clearly established on a balance of probabilities that the site development plan attached to the lease agreement was provided to intentionally ‘misinform’ Mattress House.¹⁵⁶

Mattress House’s alternative argument, in short, was that Investec’s failure to comply with the zoning laws made both the lease agreement and demand guarantee illegal.¹⁵⁷ Moreover, Mattress House argued that the lease was in fact concluded in furtherance of an illegal purpose.¹⁵⁸

In dealing with this allegation, the court confirmed that illegality evokes the maxim, *ex turpi causa non oritur action* (referred to above). The court asked Mattress House to answer whether or not the illegality rendered the demand guarantee *void ab initio*.¹⁵⁹ In response, Mattress House submitted that once the binding nature of the correspondence sent by the municipality regarding their decision was established, it would prove that the premises were illegal, which would in turn also establish *prima facie* that the lease agreement concluded was unlawful and unenforceable. Accordingly, the occupation of the premises would also be unlawful.¹⁶⁰

152 Paragraphs 14, 19 and 26.

153 Paragraph 14.

154 Paragraphs 26 and 23 (this para 23 should be numbered para 27).

155 Paragraph 24 (should be numbered para 28).

156 Paragraph 25 (should be numbered para 29).

157 Paragraphs 19 and 26 (this para 26 should be numbered para 30).

158 Paragraph 28 (should be numbered para 32).

159 Paragraph 26 (should be numbered para 30).

160 *ibid.*

The court then moved to deal with the nature of a town-planning scheme.¹⁶¹ The court sought to establish the legislative nature and purpose of a town-planning scheme and endorsed Masipa J's view made in *Muangisa Ntangu-Reare v City of Johannesburg*:¹⁶²

A town planning scheme is a unique piece of legislative arrangement in terms of which each erf with in the geographical area covered by a scheme has a specific zoning attached to it, which is owning permits only certain uses specified in the scheme itself ... and occupier or owner of an Erf either uses the property for the purpose is permitted by the scheme, or he does not.

Against this background, the court expressed its discomfort with Mattress House's allegation that the lease agreement was entered into for an illegal purpose.¹⁶³ The court summarised that the alleged illegality pertained to an alleged failure by Investec to comply with the Sandton Town Planning Scheme. It added that from the correspondence furnished by the municipality it was implied that the apparent contravention was capable of rectification by submission of the required site development plan; and it was not the kind of contravention where the underlying contract and/or demand guarantee were entered into for 'criminal purposes or in furtherance of an unlawful purpose.'¹⁶⁴

The court did not classify the contravention of the Sandton Town Planning Scheme as 'illegal', but it did consider illegality as a general defence to payment in a demand guarantee transaction. In this regard, Siwendu J said:¹⁶⁵

[T]he illegality complained of can only be a valid defence where it extends to and directly affects the Guarantee. The Guarantee must have been entered into for a criminal purpose or in furtherance of an unlawful purpose. Even though I do not purport to set out a general principle, it is conceivable that there may be instances where the nature of the illegality complained of vitiates the Guarantee. An example would be where the issuing bank becomes aware of the transaction as part of a money laundering scheme or in the case of a breach of exchange control regulations. This is not such a case. [Emphasis added.]

The court stressed that the question regarding the alleged illegality of the lease (underlying contract) was in any event not answered and the matter was still pending before the Randburg Magistrates' Court. Therefore, the court concluded that Mattress House had failed to establish a *prima facie* right for the interim relief, and the balance of convenience also did not favour the relief. Furthermore, there were also other alternative remedies available to Mattress House to make use of in due course. For

161 Paragraph 27 (should be numbered para 31).

162 Unreported, delivered on 15 November 2012.

163 *Mattress House* (n 47) para 28 (should be numbered para 32).

164 Paragraph 28 (should be numbered para 32).

165 Paragraph 30 (should be numbered para 34).

instance, to oppose the action instituted against it by Investec and to challenge the rent interdict.¹⁶⁶ Therefore, the application for the interim interdict was dismissed and Mattress House was accordingly ordered to pay the costs of the application, in this case, together with the costs of the earlier application dated 28 September 2017.¹⁶⁷

At the outset, we indicated that our primary focus was on illegality as an exception to the independence principle, and therefore we will make only a few brief comments relating to how the court in the *Mattress House* case dealt with the fraud exception for completeness. Siwendu J, in the *Mattress House* case, correctly pointed out that Mattress House had to show a fraudulent intention on the part of Investec (beneficiary). Mattress House, however, failed to establish a convincing case and provide clear evidence in this regard. The dismissal of this defence can therefore be supported. It is submitted that the judgment in the *Mattress House* case, in this respect, is correct.

Although Siwendu J clearly and correctly accepted the fraud exception, she seemingly and unfortunately, favours the view that the fraud exception may be enforced only where the forgery or falsification concerned the documents (ie, where there is fraud in the narrow sense), and not also fraud relating to the performance by the beneficiary in terms of the underlying contract (ie, where there is fraud in the wide sense). Support for this deduction is found in her statement:¹⁶⁸

the prevailing view has been that in matters dealing with the payment of a Guarantee, the fraud alleged must be in respect of the presentation thereof and does not extend to wider contractual inducements for which a bank [guarantor] . . . cannot be aware.

Although the South African courts have not pronounced specifically on this matter, there is convincing support for the belief that fraud justifying interference with the beneficiary's claim to payment is not restricted to the falsification or forgery of

166 Paragraph 31 (should be numbered para 35).

167 Paragraph 32 (should be numbered para 36). *Bombardier Africa Alliance Consortium v Lombard Insurance Company Limited & Another* (A222/2019) [2020] ZAGPPHC 554 (7 October 2020) concerned an application to bar payment under a demand guarantee pending the final determination of a dispute between the parties. Prior to this application for an interim interdict, it was found during alternative dispute resolution ('ADR') proceedings that the beneficiary was at fault. To satisfy the *prima facie* requirement of the interim interdict the applicant alleged two grounds for non-payment of the guarantee, namely non-compliance with the terms of the guarantee and fraud (para 11). The court upheld the independence principle and stated that it was not fraudulent for a beneficiary, who had made a proper demand in terms of the guarantee, to insist on payment while awaiting the final determination of a dispute between the parties (paras 21–26 and 28). The application for the interdict thus failed, despite the earlier ADR decision that the beneficiary was at fault.

168 Paragraph 26.

documents (fraud in the narrow sense), but also embraces fraud committed by the beneficiary in the underlying contract (fraud in the wide sense).¹⁶⁹

Siwendu J followed a sound approach in her dealing with the alleged illegality in the case before her. She correctly refused to grant the interim interdict. Although Siwendu J did not want to declare that illegality in the underlying contract generally constituted an exception to the independence principle, she did state that it was ‘conceivable that there may be instances where the nature of the illegality complained of vitiates the Guarantee.’¹⁷⁰ She also had regard to the precise nature (gravity/seriousness) of the illegality contended. As already mentioned, illegality may arise in two ways.¹⁷¹ First, the guarantee itself may be illegal. In such an instance, the issuance of the guarantee may, for example, be prohibited by any binding law. Second, where the illegality relates to the unlawfulness of the underlying contract. The effect of the second form of illegality is that the guarantee may be tainted by the illegality in the underlying contract. An example of this would be where the underlying contract is entered into for an unlawful or criminal purpose. The facts in *Mattress House* fall within the ambit of the second form of illegality. Accordingly, the correspondence received from the City of Johannesburg indicates a contravention that relates to the unlawfulness of the underlying contract. However, the contravention, according to Siwendu J, was capable of rectification. Thus, upon the submission of a site development plan to the City of Johannesburg, the contravention would cease to exist. It is submitted that the possibility of rectification demonstrates that the contravention was not serious enough to justify judicial intervention. Overall, Siwendu J was of the view that the guarantee was not directly affected (tainted) by the illegality in the underlying transaction; that the illegality involved in the case was not that serious; and the alleged illegality could be rectified. Support for her approach is found in the *Mahonia* case, where Colman J first considered the nature (gravity/seriousness) of the illegality in determining whether or not a standby letter of credit was also illegal and/or unenforceable.¹⁷² Cooke J agreed that the permissibility of the enforcement of a letter of credit depended on the gravity of the illegality alleged. Siwendu’s reasoning is, thus, clearly aligned with that of Staughton LJ in the English case *Group Josi Re Co SA v Walbrook Insurance Co Ltd*¹⁷³ and the judges in the *Mahonia* cases. This line of reasoning should, it is submitted, be supported.

169 For detailed discussions, see Kelly-Louw (n 14) 202–204; Charl Hugo and Michelle Kelly-Louw, ‘Documentary Credits and Independent Guarantees’ *ABLU* 2010 (paper delivered at the 2010 Annual Banking Law Update held at the Indaba Hotel, Johannesburg on 21 April 2010) 207 at 218–219; Van Niekerk and Schulze (n 16) 295–296.

170 *Mattress House* (n 47) para 30 (should be numbered para 34).

171 Horowitz (n 37) 224 paras 7.80–7.81.

172 *Mahonia* (n 96) 915 paras 11–12 and 927–928 para 69.

173 1996 1 WLR 1152.

Siwendu J's judgment recognises that a guarantor or issuer may refuse to pay a beneficiary where a demand guarantee (or a letter of credit) is entered into for a criminal or unlawful purpose and/or used to carry out an illegal underlying contract/transaction, provided that the demand guarantee is directly affected (tainted) by the illegality in the underlying contract. This position is also supported by Kelly-Louw.¹⁷⁴ She stresses that the illegality must be so serious that it extends to and influences the demand guarantee itself.¹⁷⁵ The importance of the *Mattress House* judgment is that it recognises that the illegality of the underlying contract may, in compelling instances, provide a valid defence to claims under demand guarantees provided that the contraventions of the law are of such a serious nature (eg, involving a criminal element) that they warrant judicial intervention based on, it is submitted, public policy considerations.

The court, moreover, found it fit to provide two examples where illegality in the underlying contract may provide an exception to the independence principle. In the first place, it referred to an instance in which the underlying transaction may be involved in a money-laundering scheme. As already mentioned, it is important to remember that trade and financial sanctions imposed against a specific country may also cause a demand guarantee/letter of credit to be illegal itself. If the demand guarantee itself is illegal, but the underlying contract is legal, the principle of independence will not come into play and the payment will be prohibited simply because the instrument itself is illegal and unenforceable.

In the second place, as indicated above, the court referred to a breach of exchange control regulations. This example presented itself before an English court in *United City Merchants v Royal Bank of Canada*.¹⁷⁶ In this case, a letter of credit was used in a sale transaction in which inflated invoices were used to circumvent statutory exchange control regulations. These regulations, however, did not form part of English law but rather Peruvian law.¹⁷⁷ In this regard, it must be borne in mind that English law accepted an international monetary fund agreement generally known as the Bretton Woods Agreement. Article VIII(2)(b) of the Bretton Woods Agreement provides that:

Exchange contracts which involve the currency of any member and which are contrary to the exchange control regulations of any member maintained or imposed consistently with this agreement shall be unenforceable in the territories of any member.

Against this background, Lord Diplock held that the whole transaction (ie, the underlying contract and the letter of credit itself) was in breach of Peruvian exchange control regulations and was therefore unenforceable in England. He denied enforcement

174 Kelly-Louw (n 40) 354.

175 *ibid*.

176 See (n 37).

177 At 198D–E.

of the transaction owing to it contravening the exchange control regulation. He put it as follows:¹⁷⁸

If in the course of the hearing of an action the court becomes aware that the contract on which a party is suing is one that this country has accepted an international obligation to treat as unenforceable, the court [...] must refuse to lend its aid to enforce the contract. But this does not have the effect of making an exchange contract that is contrary to the exchange control regulation of a member state other than the United Kingdom into a contract that is ‘illegal’ under English law or render acts undertaken in this country in performance of such a contract unlawful. Like a contract of guarantee of which there is no note or memorandum in writing it is unenforceable by the courts and nothing more.

Although the court in *United City Merchants* did not consider the contract to be illegal but rather unenforceable, it was, however, undoubtedly in favour of allowing a financial institution to deny payment under a letter of credit if it is aware of the transaction’s being a monetary operation contrary to exchange control regulations.¹⁷⁹

Concluding Remarks

The ICC and the UNCITRAL have both been proactive in trying to find solutions to the problems caused by fraudulent and unfair draws made on demand guarantees and letters of credit.¹⁸⁰ The ICC rules generally make no provision for the illegality exception or offer any guidance on how to deal with such an exception.¹⁸¹ In contrast, the UNCITRAL Convention specifically provides for an illegality exception where the underlying contract was declared invalid by an arbitral tribunal or court¹⁸² in the states (jurisdictions) that the Convention applies to.¹⁸³ Given that neither South Africa nor England has ratified or acceded to the UNCITRAL Convention, the Convention offers little assistance and guidance to these two jurisdictions as to how they should or should not deal with the illegality exception.

Van Niekerk and Schulze correctly stress that one should distinguish between a situation where the underlying contract is merely invalid (or unenforceable), but not also illegal.¹⁸⁴ They are correct in stating that an invalid underlying contract has no effect on the validity and enforceability of the obligation in terms of a demand guarantee/letter of credit itself.¹⁸⁵ Where the underlying contract is illegal, it is important first to establish

178 At 189B–C.

179 At 190E–F. In this regard, the other Lords concurred in Lord Diplock’s judgment at 190–191.

180 Kelly-Louw LLD (n 1) para 8.5.

181 Except for URDG 758 providing some guidance—see the discussion in (n 41).

182 Kelly-Louw LLD (n 1) para 6.5; Kelly-Louw (n 40) 381; Enonchong (n 42) 205–206 para 8.53.

183 For more on this, see Kelly-Louw LLD (n 1) para 6.5; Kelly-Louw (n 40) 381–382.

184 Van Niekerk and Schulze (n 16) 298.

185 *ibid.* See Enonchong (n 42) in fn 1 at 185.

whether that illegality is serious and, if so, to establish after that whether it also extends to and influences (or taints) the demand guarantee itself. If the demand guarantee is, indeed, affected by the illegality in the underlying contract, the principle of independence of the guarantee may be infringed.¹⁸⁶ The *Mattress House* case illustrates that depending on the seriousness of the illegality in the underlying contract, there are instances where the guarantor/issuer will still be obliged to pay in terms of the independent payment obligation set out in the demand guarantee/letter of credit.¹⁸⁷ It also confirms that the type of illegality that would constitute an exception would have to have a criminal element or at least further an unlawful purpose.

Although the remarks made by court in the *Mattress House* case regarding illegality are regarded as *obiter dicta*, they demonstrate the South African judiciary's willingness to accept illegality, in an appropriate case, as an exception to the independence principle. The view that fraud is the only accepted exception to the independence principle in the South African law is thus no longer true. Siwendu J's judgment regarding the acceptance of the illegality exception is an indication that our courts are committed to further aligning the South African law relating to demand guarantees with English law.

The *Mattress House* judgment is consistent with the English case law and scholarly writings regarding the illegality exception. Most patently, *Mattress House* also identifies certain identical minimum requirements that need to be met for the illegality exception to be accepted, namely that the illegality must be sufficiently serious and the demand guarantee/letter of credit must be sufficiently connected to (or tainted by) the illegality in the underlying contract/transaction. But, just as with the English cases, it offers little guidance as to how these requirements can be met. *Mattress House* gives some guidance about when the illegality will be considered to be serious, but offers nothing as to when it will be considered that the illegality taints or directly affects the demand guarantee. Unfortunately, the *Mattress House* case is silent regarding the standard of proof of the illegality that is required, and it is assumed that in following the English law and the standard for fraud, that the standard of proof required is likely to be 'clear evidence of illegality'. The case is also silent regarding whether or not the beneficiary must have been complicit in or have knowledge of the illegality for the illegality exception to be accepted; and, again, it is expected that the South African courts will turn to English case law for guidance. Just as under the English law, the illegality exception in South Africa is not fully settled and its scope remains undefined. The acceptance of the illegality exception under English law has come a long way, although it is not completely settled, while the exception in South Africa is still in its infancy.

186 Enonchong (n 39) 407.

187 See also Van Niekerk and Schulze (n 16) 298.

We support the acceptance of the illegality exception on the basis of policy considerations. However, the exception should be given a narrow application and apply only in exceptional cases where the only reasonable inference to make is that of illegality, just as is the case with fraud as an exception, because of the significance of the independence principle in supporting international trade. The independence principle should be deviated from only under very restrictive circumstances. As a minimum, the alleged illegality must be clearly established, be sufficiently serious and the illegality in the underlying contract must directly affect or taint the demand guarantee. We, like Hewetson and Mitchell,¹⁸⁸ are not convinced that the beneficiary must necessarily be complicit in or have knowledge of the illegality for the illegality exception to apply. To determine whether an underlying contract is illegal may sometimes be complex and technical and, accordingly, there may be instances where the beneficiary would have no knowledge that the underlying contract is, in fact, illegal, but where the illegality should still, because of policy considerations, operate as an exception. Of course, the latter should be possible only provided the aforementioned minimum requirements have also been met.

Generally, if the guarantor/issuer is aware of the illegality in the underlying contract, it must not pay. However, if the guarantor has some suspicion of it only, but not actual knowledge of illegality or cannot prove the illegality, the guarantor should pay. It is only where the guarantor has clear evidence of illegality that it should not pay.

188 Hewetson and Mitchell (n 1) 160.

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