

## ARTICLES

### DEMAND GUARANTEES IN THE PEOPLE'S REPUBLIC OF CHINA AND THE REPUBLIC OF SOUTH AFRICA\*

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*Guarantees play an important role in large commercial contracts internationally. Guarantees can be either independent (demand) guarantees or accessory guarantees. The legal consequences of the two differ significantly and, therefore, it is important to differentiate clearly between the two. In the case of independent (demand) guarantees – the focus of this contribution – the guarantor's liability is independent of the underlying performance it is guaranteeing, and is accordingly to be determined, in principle, with reference only to the terms of the guarantee. However, this is not an absolute principle. Jurisdictions throughout the world recognize exceptions to this principle, the most important and prevalent being fraud on the part of the beneficiary. A Judicial Interpretation by the Supreme People's Court of the People's Republic of China relating to independent guarantees came into operation in December 2016. Its rules depart in some important respects from the law of guarantees in South Africa, both in relation to the determination of the nature of the guarantee (as independent or accessory) and in relation to the exceptions to the principle of independence. This article explores these issues against the background of the law of contract of both countries.*

*Keywords: independent guarantee; demand guarantee; accessory guarantee; suretyship; independence of guarantee; autonomy of guarantee; fraud; abuse of rights; Chinese Judicial Interpretation relating to independent guarantees; Uniform Rules for Demand Guarantees; China; South Africa.*

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## Table of Contents

### Introduction

#### 1. Demand Guarantees

##### 1.1. *Introductory Issues*

##### 1.2. *International Rules*

##### 1.3. *Definition of “Demand Guarantee”*

##### 1.4. *Practical Example*

#### 2. The South African Law

##### 2.1. *Introduction*

##### 2.2. *Independent (Demand) Guarantees and Accessory Guarantees Distinguished*

##### 2.3. *Independence and Exceptions to Independence*

#### 3. Chinese Law

##### 3.1. *Introduction: Sources of the Chinese Law of Contract*

##### 3.2. *Independent (Demand) Guarantees and Accessory Guarantees Distinguished*

#### 4. Comparative Analysis

##### 4.1. *Determining Whether a Guarantee Is Independent or Accessory*

##### 4.2. *Independence and Exceptions to Independence*

### Conclusion

## Introduction

BRICS is about cooperation amongst its members. In accordance with its South African-hosted website this cooperation “is informed by the need to deepen, broaden and intensify relations within the grouping and among the individual countries for more sustainable, equitable and mutually beneficial development,”<sup>1</sup> and is predicated upon three different tracks of interaction namely (i) formal diplomatic engagement between governments, (ii) engagement through government-affiliated institutions, and (iii) civil society and people-to-people engagement.<sup>2</sup>

<sup>1</sup> What is BRICS, Africa Facts (Apr. 15, 2019), available at <https://africa-facts.org/what-is-brics/>.

<sup>2</sup> *Id.* A good example of a combination of tracks (ii) and (iii) is the collaborative reaching out by universities in different BRICS countries (and researchers and teachers in them) towards one another. This should undoubtedly act as powerful catalyst for meaningful research on BRICS issues. Such an agreement was formally concluded on 1 November 2018 between the law faculties of the University of Johannesburg (in South Africa) and the University of Tyumen (in Russia) respectively during the Third Siberian Forum (which focused on BRICS issues) held in Tyumen during the period 1–3 November 2018.

Lawyers will be alive to the fact that “sustainable, equitable and mutually beneficial development” requires strong legal intervention. In this regard a mutual understanding of, and respect for, the legal systems of the different BRICS countries is important. Moreover, the legal systems of the different BRICS countries present exceptionally fertile soil for the comparative lawyer. The history of these five countries reflects a wide diversity of ideologies from the West, the East, Latin America and Africa – influences arising from different economic and religious systems and backgrounds are clearly evident.<sup>3</sup> They further represent civilian,<sup>4</sup> common-law<sup>5</sup> and mixed jurisdictions.<sup>6</sup> In fact, I would be bold enough to state that it is difficult to conceive in general of more fertile and diverse legal comparative material, if one were to select five countries only, than that emerging from the law of Brazil, Russia, India, China and South Africa.

South Africa is one of the leading economies in Africa.<sup>7</sup> China is investing heavily in Africa, mainly in relation to the construction of railway lines and

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<sup>3</sup> Capitalism, socialism and communism, African custom, Confucianism, Hinduism, Islam and Christianity – to name some of the more obvious.

<sup>4</sup> Brazil, Russia and China are all generally regarded as sharing essentially, civilian roots. Regarding Brazil see Jan Kleinheisterkamp, *Development of Comparative Law in Latin America in The Oxford Handbook of Comparative Law* 261 (M. Reimann & R. Zimmermann (eds.), Oxford: Oxford University Press, 2006) who refers to the oversimplified and superficial notion that Latin American law is “largely an offspring of and, at best, a variation of French law” (262), and goes on to remark on the strong influence of the “*usus modernus pandectarum*, as reflected by contemporary German and Dutch doctrines” in Brazil (266). Due to its tumultuous history the position in Russia is complex. Nevertheless Russian law is generally regarded as falling, historically, within the Romano-Germanic family of law. See in this regard René David & John E.C. Brierley, *Major Legal Systems of the World Today* 124 (3<sup>rd</sup> ed., London: Stevens & Sons Ltd., 1985). On the more recent influence of Western European (civilian) law on Russia as a post-socialist economy see Esin Örüçü, *Comparatists and Extraordinary Places in Comparative Legal Studies: Traditions and Transitions* 467, 474–477 (P. Legrand & R. Munday (eds.), Cambridge: Cambridge University Press, 2003). Finally, regarding China, see Zentaro Kitagawa, *Development of Comparative Law in East Asia in The Oxford Handbook of Comparative Law*, *supra*, at 237, 257 who describes Chinese law as having strong German pandectist roots but moving towards a more pragmatic approach. Chinese law being a particular focus of this article, I return to aspects of it in more detail below.

<sup>5</sup> India, as former British colony, is generally regarded as a common-law country. See, e.g., H. Patrick Glenn, *Legal Traditions of the World: Sustainable Diversity in Law* 312 (5<sup>th</sup> ed., New York: Oxford University Press, 2014) who refers to the replacement of Hindu law by English inspired statutes in the nineteenth century that amounted to a “virtually complete codification of all fields of commercial, criminal and procedural law.” The author actually refers to Indian law as “Anglo-Indian law.”

<sup>6</sup> South Africa, with its complex colonial history involving roots in the Netherlands and France, followed by British occupation, is generally regarded as a mixed jurisdiction. See *Introduction to the Law of South Africa* ix, xi–xiv (C.G. van der Merwe & J.E. du Plessis (eds.), The Hague: Kluwer Law International, 2004); Deon H. van Zyl, *Beginnels van Regsvergelyking* 284 *et seq.* (Durban: Butterworth, 1981); K. Zweigert & H. Kötz, *An Introduction to Comparative Law* 231 *et seq.* (T. Weir (trans.), Oxford: Clarendon Press, 1998); C.G. van der Merwe et al., *The Republic of South Africa in Mixed Jurisdictions Worldwide: The Third Legal Family* 95, 95 *et seq.* (V.V. Palmer (ed.), 2<sup>nd</sup> ed., Cambridge: Cambridge University Press, 2012). South African law being a particular focus of this article, I return to aspects of it in more detail below.

<sup>7</sup> According to statistics drawn from the International Monetary Fund (IMF) and based on its gross domestic product (GDP) in 2017 of \$349 299bn, South Africa is the second largest economy in Africa (after Nigeria with a GDP of \$376 284bn). See, in this regard, Top 10 Wealthiest African Countries According to GDP, IT News Africa, 2 July 2018 (Apr. 15, 2019), available at <http://www.itnewsafrica.com/2018/07/top-10-wealthiest-african-countries-according-to-gdp/>.

energy.<sup>8</sup> Such investments typically require complex commercial contracts which often contain different types of financial and/or construction guarantees involving very large amounts of money. When things go wrong, or even threaten to go wrong, such guarantees may be called up. This, sometimes, leads to litigation or arbitration, and a clear conception of the law relating to guarantees becomes important. Choice-of-law clauses in the contracts, or the principles of private international law, may, where China is operating in Africa, lead, *inter alia*, to the application of South African or Chinese law. Chinese and South African law regarding guarantees, however, contain significant differences in some important respects.

Against this background the intention with this article is to serve BRICS ideals by contributing to a better understanding of the legal implications and effects of guarantees that may be encountered in contracts arising from Chinese investments and construction in Africa. To do so I deal first briefly with the general commercial purpose and basic tenets of these guarantees. Thereafter the South African and Chinese law relating to these instruments is explored in more detail against the background of relevant developments in the law of contract of both countries. The article concludes with a brief comparative analysis.

## 1. Demand Guarantees

### 1.1. Introductory Issues

This article deals mainly with “independent” or “demand” guarantees. However, a guarantee can also be “accessory.” In fact, when dealing with a guarantee, the first important step is to determine whether it is independent or accessory.<sup>9</sup> In the case of an independent guarantee a second question arises, namely what the extent of the independence is (which includes the question whether the law should allow exceptions to this independence). These two questions are explored in this article with the purpose of determining the extent to which the South African and Chinese law are in harmony or differ.<sup>10</sup>

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<sup>8</sup> On 6 September 2018 Brookings reported an announcement by President Xi Jinping pledging \$60bn dollars investment into Africa, most of which relates to transport (mainly the building of railway lines) and energy. See Mariama Sow, *Figures of the Week: Chinese Investment in Africa*, Brookings, 6 September 2018 (Apr. 15, 2019), available at <https://www.brookings.edu/blog/africa-in-focus/2018/09/06/figures-of-the-week-chinese-investment-in-africa/>.

<sup>9</sup> Ningning Zhang, *Independent or Dependent: Chinese Rules of Interpretation for Determining the Nature of Guarantees*, 29(2) *Journal of International Banking Law and Regulation* 114, 114 (2014) uses the terms “ancillary” or “dependent” instead of my favoured term “accessory.”

<sup>10</sup> See also Charl Hugo, *Demand Guarantees: Insights from the People’s Republic of China* in *Jopie: Jurist, Mentor, Supervisor and Friend – Essays on the Law of Banking, Companies and Suretyship* 129 et seq. (C. Hugo & M. Kelly-Louw (eds.), Cape Town: Juta, 2017), in which aspects of these questions are considered.

## 1.2. International Rules

Rules drafted by international bodies are often contractually incorporated into such guarantees by the parties. Two sets of rules are especially important in this regard. The most important, probably, are the *Uniform Rules on Demand Guarantees (URDG)* prepared by the Banking Commission of the International Chamber of Commerce (ICC). The current revision dates back to 2010 and is typically referred to as the *URDG 758*.<sup>11</sup> A competing set of rules, the *International Standby Practices*,<sup>12</sup> was drafted and published in 1998 by the Institute of International Banking Law & Practice (IIBLP) in America. This second set of rules, commonly referred to as the *ISP 98*, received the blessing of the ICC in 1998 by indorsement and publication as an ICC text.<sup>13</sup> An earlier effort to unify this part of law internationally by the United Nations Commission on International Trade Law (UNCITRAL) in the form of a convention, the *United Nations Convention on Independent Guarantees and Stand-by Letters of Credit* (adopted by the General Assembly on 11 December 1995)<sup>14</sup> has only attracted very little support<sup>15</sup> and is disregarded in the remainder of this contribution.

## 1.3. Definition of “Demand Guarantee”

Before embarking upon a discussion and analysis of the South African and Chinese law regarding demand guarantees, it is apt to form a general understanding of this type of instrument from more “neutral” territory. The *URDG 758* is useful in this regard. Article 2 contains the following helpful definitions:

**Demand guarantee or guarantee** means any signed undertaking, however named or described, providing for payment on presentation of a complying demand;

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<sup>11</sup> ICC Publication No. 758 (2010). It was preceded by an earlier version, the *URDG 458* (ICC Publication No. 458 (1992)). For a comprehensive commentary of the *URDG 758* see Georges Affaki & Roy Goode, *Guide to ICC Uniform Rules for Demand Guarantees (URDG 758)* (Paris: International Chamber of Commerce, 2011). See further in general on the *URDG* Charl Hugo, *Letters of Credit and Demand Guarantees: A Tale of Two Sets of Rules of the International Chamber of Commerce*, 1 *Journal of South African Law* 1, 3–6, 14–16 (2017); 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*, LL.D. Thesis, University of Johannesburg (2017), para. 3.2.1.

<sup>12</sup> A standby letter of credit is essentially an independent guarantee widely encountered in the United States, especially (but not only) when financial obligations are secured. See in this regard Goode on *Commercial Law* 1087–1088 (E. McKendrick (ed.), 5<sup>th</sup> ed., London: Penguin Books, 2016).

<sup>13</sup> ICC Publication No. 590 (1998).

<sup>14</sup> The main work was done by the UNCITRAL Working Group on International Contract Practices. See United Nations Convention on Independent Guarantees and Stand-by Letters of Credit (New York, 1995) (Apr. 15, 2019), available at [http://www.uncitral.org/uncitral/en/uncitral\\_texts/payments/1995Convention\\_guarantees\\_credit.html](http://www.uncitral.org/uncitral/en/uncitral_texts/payments/1995Convention_guarantees_credit.html); Marxen 2017, para. 3.2.3.

<sup>15</sup> The Convention was ratified by the following countries only (for whom it entered into force on 1 January 2000): Belarus, Ecuador, El Salvador, Gabon, Kuwait, Liberia, Panama and Tunisia. See United Nations Convention, *supra* note 14.

**Complying demand** means a demand that meets the requirements of a complying presentation; [and]

**Complying presentation** under a guarantee means a presentation that is in accordance with, first, the terms and conditions of that guarantee, second, these rules so far as consistent with those terms and conditions and, third, in the absence of a relevant provision in the guarantee or these rules, international standard demand guarantee practice; <...>

Article 4 goes on to explain that a demand guarantee is “irrevocable on issue” and, then, crucially, Article 5(a) provides as follows:

A guarantee is by its nature independent of the underlying relationship... and the guarantor is in no way concerned with or bound by such relationship. A reference in the guarantee to the underlying relationship for the purpose of identifying it does not change the independent nature of the guarantee. The undertaking of a guarantor to pay under the guarantee is not subject to claims or defences arising from any relationship other than a relationship between the guarantor and the beneficiary.

From these building blocks it is clear that a demand guarantee (as contemplated in the *URDG 758*) should contain the following elements: (i) it must be an irrevocable undertaking by a guarantor to pay the beneficiary on receipt of a demand from the beneficiary that is in conformity with the terms of the guarantee; and (ii) the guarantor’s undertaking must be independent of the debt relationship between the beneficiary and its debtor in the underlying debt relationship. This latter element sets the demand guarantee apart from an accessory guarantee or suretyship where the guarantee is accessory to the underlying debt relationship – hence, in the case of an accessory guarantee, any defence available to the principal debtor in the underlying relationship can be raised by the guarantor against the beneficiary of the guarantee. Such defences are, however, precluded in the case of a demand guarantee.

Although the *URDG 758* does not expressly recognize any exception to the independence of the guarantor’s obligations in the case of a demand guarantee, this does not mean that there are none. The position is simply that the drafters of the *URDG* deemed it best to leave this aspect to be resolved by domestic law.<sup>16</sup> This has led to different outcomes in different countries.

#### **1.4. Practical Example**

Before moving on to consider the approach of South African and Chinese law to the two questions posed in paragraph 1.1 above, this introduction concludes

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<sup>16</sup> See Affaki & Goode 2011, at 243, para. 5.10.

with a practical example of the typical use of a demand guarantee in a construction project.

The Government of country A wishes to build a dam on land owned by it. The contract is awarded to company B. To secure itself against the detrimental financial consequences should B perform poorly or not at all, A, in the construction contract, requires of B to provide A with a performance guarantee, issued by a reputable bank, C, for an amount of, for example, 10% of the contract price. To comply with its obligations under the construction contract B accordingly requests C to issue such a guarantee. C is only likely to do so if it is satisfied with the creditworthiness of B or has received sufficient security from B, since, if the guarantee is called up, C will seek reimbursement from B. C issues the guarantee which provides that it will be paid on first written demand by A to C. The guarantee further provides that the demand must meet certain specific requirements namely: (i) it must allege that A has cancelled the contract with B due to defective performance by B; and (ii) it must have annexed to it the notice of cancellation of the contract.<sup>17</sup> During the course of the project a dispute develops between A and B as to whether B is building properly. Against this background A cancels the contract with B and demands payment in terms of the guarantee. Provided the demand is conforming (that is meets the two requirements set out immediately above) C must pay. Whether in fact B's performance justified A to cancel the construction contract is totally irrelevant since the question whether C is liable under the guarantee, due to the independence of the guarantee, is to be determined with reference only to the guarantee and not with reference to the underlying construction contract.

## 2. The South African Law

### 2.1. Introduction

As mentioned above, South African law belongs to the family of mixed jurisdictions. Zimmermann succinctly describes it as follows:

[South African law] has inherited a system of private law that is based on the Dutch variant of the *ius commune* prevailing, for many centuries, in continental Europe. Unlike the continental legal systems, but like the English common law, Roman-Dutch law in South Africa has never been codified. As a result we find Courts and legal writers having to grapple, even today, with the historical sources of the *ius commune*. Particular emphasis, of course, is placed on 17<sup>th</sup> and 18<sup>th</sup> century Dutch authorities like Grotius, Groenewegen, Voet and Vinnius; but other works from the entire library of learned literature from Bartolus to Windscheid, and even the sources of Roman law itself, are regularly cited in

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<sup>17</sup> Note that although these requirements are common in South African construction guarantees, they are not prescribed requirements. The requirements of the beneficiary's demand are whatever the guarantee may state in this regard.

areas like contract... From the early 19<sup>th</sup> century, however, English law started to exercise a significant influence on the law prevailing in [South Africa]... and a complex process was set in motion that ultimately transformed Roman-Dutch law in South Africa into a mixed legal system with its own identity...<sup>18</sup>

Although large parts of South African law is statutory law, the law of guarantees is part of the uncodified (and mainly civilian) law of contract in South Africa. Guarantees are not regulated by statute. It should further be noted that one of the main aspects of English law that has been inherited is the *stare decisis* doctrine, in other words, that the decisions of the high courts are binding.

Two further points regarding South African law need to be highlighted. The first is that large parts of especially commercial law have been heavily influenced by English law, both in substance and character.<sup>19</sup> This is certainly the case in relation to banking law in general and the law of bank demand guarantees in particular. In practice this has meant that the South African courts have been heavily influenced by English case law relating to demand guarantees.<sup>20</sup>

The second point to be emphasized is that the advent of full democracy in the country in 1994, heralded a new constitutional dispensation. South Africa became a constitutional state in which the constitution is the highest law of the land. Chapter 2 of the constitution contains the Bill of Rights. Of particular importance for the purposes of this article is that the final section of the Bill of Rights places an obligation on the courts to develop the law. Section 39(2) reads as follows:

When interpreting any legislation, and when developing the common law or customary law, every court, tribunal or forum must promote the spirit, purport and objects of the Bill of Rights.

## **2.2. Independent (Demand) Guarantees and Accessory Guarantees Distinguished**

In some instances it is clear that a guarantee is indeed independent. This is especially so when the guarantee is issued subject to the *URDG 758*<sup>21</sup> or the *ISP*

<sup>18</sup> See *Introduction to the Law of South Africa*, *supra* note 6, at xi.

<sup>19</sup> *Id.*

<sup>20</sup> See *The Law of Banking and Payment in South Africa* 438 (R. Sharrock (ed.), Cape Town: Juta, 2016). See also Charl Hugo, *Construction Guarantees and the Supreme Court of Appeal (2010–2013) in Essays in Honour of Frans Malan* 159 (C. Visser & J.T. Pretorius (eds.), Durban: LexisNexis, 2014). See further *Dormell Properties 282 CC v. Renasa Insurance Co. Ltd. and Another*, 2011 (1) S.A. 70 (S.C.A.); *Minister of Transport and Public Works, Western Cape and Another v. Zanbuild Construction (Pty) Ltd. and Another*, 2011 (5) S.A. 528 (S.C.A.); and *Coface South Africa Insurance Co. Ltd. v. East London Own Haven t/a Own Haven Housing Association*, 2014 (2) S.A. 382 (S.C.A.).

<sup>21</sup> As seen above the *URDG 758*, in Article 2, defines a guarantee as a “signed undertaking, however named or described, providing for payment on presentation of a complying demand.” Article 5 then provides as follows: “A guarantee is by its nature independent of the underlying relationship... A reference in the



98.<sup>22</sup> The question is also mostly unproblematic when a standard-form construction guarantee forming part of a standard-form industry-formulated suite of contracts is used.<sup>23</sup> However, in the event of a guarantee being drafted *ad hoc* for a specific purpose without incorporating rules such as the *URDG*, it becomes “key”<sup>24</sup> to determine whether the guarantee is independent or accessory. In at least two South African cases before the Supreme Court of Appeal, the *Minister of Transport and Public Works*<sup>25</sup> and *KNS Construction*<sup>26</sup> cases, the outcome of the case depended on whether the guarantee was accessory or independent. The approach of the South African courts in such cases is to read the guarantee as a whole and to determine from its clauses and surrounding circumstances whether the parties intended it to be independent or accessory.<sup>27</sup> In this regard its “label, title, name or heading” is not conclusive.<sup>28</sup> In the *KNS Construction* case the court put it thus:

In order to resolve the question whether the guarantee is “a call guarantee” [demand guarantee] or “a conditional guarantee” [accessory guarantee], it is apt to restate what this court said about interpreting documents. In *Novartis SA v Maphil Trading* [2016 1 SA 518 SCA par 27]... this court said:

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guarantee to the underlying relationship for the purpose of identifying it does not change the independent nature of the guarantee. The undertaking of a guarantor to pay under the guarantee is not subject to claims or defences arising from any relationship other than a relationship between the guarantor and the beneficiary.” These provisions read together, it is submitted, place the status of a guarantee incorporating the *URDG* almost beyond contention. It is clearly, almost invariably, independent.

<sup>22</sup> Para. 1.06, under the heading “Nature of Standbys,” provides as follows: “a. A standby is an irrevocable, independent, documentary, and binding undertaking when issued and need not so state. <...> c. Because a standby is independent, the enforce-ability of an issuer’s obligations under a standby does not depend on: i. the issuer’s right or ability to obtain reimbursement from the applicant; ii. the beneficiary’s right to obtain payment from the applicant; iii. a reference in the standby to any reimbursement agreement or underlying transaction; or iv. the issuer’s knowledge of performance or breach of any reimbursement agreement or underlying transaction.” The combined effect of these provisions, it is suggested, is that a guarantee issued subject to the *ISP 98* will clearly, almost invariably, be independent.

<sup>23</sup> For example the suites of agreements of the Joint Building Contracts Committee (JBCC) and the South African Institution of Civil Engineering’s *General Conditions of Contract* (GCC). See in this regard *The Law of Banking and Payment in South Africa*, *supra* note 20, at 439–440.

<sup>24</sup> The term is borrowed from Michelle Kelly-Louw, *Construing Whether a Guarantee Is Accessory or Independent Is Key in Jopie: Jurist, Mentor, Supervisor and Friend*, *supra* note 10, at 110.

<sup>25</sup> *Minister of Transport and Public Works*, *supra* note 20.

<sup>26</sup> *Mutual and Federal Insurance Co. Ltd. and Another v. KNS Construction (Pty) Ltd. and Another* [2016] Z.A.S.C.A. 87.

<sup>27</sup> In *Eskom Holdings SOC Ltd. v. Hitachi Power Africa (Pty) Ltd. and Another* [2013] Z.A.S.C.A. 101, para. 13 Mthiyane A.P. put it thus: “The question... is whether the... guarantee... is, on a proper interpretation of its terms, an on demand guarantee or a conditional guarantee.” See also Kelly-Louw 2017, at 111.

<sup>28</sup> Kelly-Louw 2017, at 111.

“...the interpretative process is one of ascertaining the intention of the parties – what they meant to achieve. And in doing that, the court must consider all the circumstances surrounding the contract to determine what their intention was in concluding it... and the court should always consider the factual matrix in which the contract is concluded – the text to determine the parties’ intention.”

In both the *KNS Construction* and the *Zanbuild* cases the court concluded that the formulation of the guarantees indicated an intention of accessory. In *Zanbuild*, for example, the court referred to “the assertion at the outset that the guarantee provide ‘security for the compliance of the contractor’s performance of obligations in accordance with the contract,’” as well as to the fact that “in the body of the document the bank guarantees ‘the due and faithful performance by the contractor.’” This, the court held, “accords with language associated with suretyships.”<sup>29</sup>

Kelly-Louw’s interpretation of these judgments (which might be putting it slightly too strong) is in fact that unless an intention of independence emerges clearly from the wording of the guarantee, South African courts are more likely to find it to be accessory: put differently, if the wording is ambiguous the court is more likely to find that the guarantee is accessory as opposed to independent; accessory is the default and if independence is intended this must be made clear.<sup>30</sup>

### **2.3. Independence and Exceptions to Independence**

The independence of demand guarantees is firmly entrenched in South African law. So, too, is the principle that fraud by the beneficiary may provide an exception to this independence. The law in this respect has been developed by following English precedents, some of which relate to letters of credit rather than to guarantees. The foundations of the law of these two (independent or autonomous) instruments are generally regarded, both in South Africa and England, as sufficiently similar to justify this approach.<sup>31</sup> Hence, in a case relating to a demand guarantee, *Lombard Insurance Co. Ltd. v. Landmark Holding (Pty) Ltd.*, Navsa J.A., drawing from earlier South African jurisprudence relating to letters of credit,<sup>32</sup> stated the independence principle as follows:

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<sup>29</sup> Para. 19.

<sup>30</sup> Kelly-Louw 2017, at 115.

<sup>31</sup> See, e.g., *Loomcraft Fabrics CC v. Nedbank Ltd. and Another*, 1996 (1) S.A. 812 (S.C.A.), at 816C–817D; *Union Carriage and Wagon Co. Ltd. v. Nedcor Bank Ltd.*, 1996 C.L.R. 724 (W), at 730; *Lombard Insurance Co. Ltd. v. Landmark Holding (Pty) Ltd. and others*, 2010 (2) S.A. 86 (S.C.A.), para. 20; *Dormell Properties*, supra note 20, paras. 38 (per Bertelsman A.J.A.) & 63 (per Cloete J.A.). See also *Edward Owen Engineering Ltd. v. Barclays Bank International Ltd.* [1978] Q.B. 159 (C.A.), at 169A; *Intraco Ltd. v. Notis Shipping Corporation (The “Bhoja Trader”)* [1981] 2 Lloyd’s Rep. 256 (C.A.), at 257.

<sup>32</sup> *Loomcraft Fabrics*, supra note 31, at 815G-I.

The guarantee... is not unlike irrevocable letters of credit issued by banks and used in international trade, the essential feature of which is the establishment of a contractual obligation on the part of a bank to pay the beneficiary (seller). This obligation is wholly independent of the underlying contract of sale and assures the seller of payment of the purchase price before he or she parts with the goods being sold. Whatever disputes may subsequently arise between buyer and seller is of no moment insofar as the bank's obligation is concerned. The bank's liability to the seller is to honour the credit. The bank undertakes to pay provided only that the conditions specified in the credit are met.<sup>33</sup>

The fraud exception to the independence principle was clearly recognized for the first time in a letter of credit case, *Phillips v. Standard Bank of South Africa Ltd.*<sup>34</sup> In his judgment, however, Goldstone J.A. traced it back historically to a much earlier American case, *Sztejn v. J. Henry Schroder Banking Corporation*,<sup>35</sup> in which Shientag J. stated that the "principle of the independence of the bank's obligation" should not be extended "to protect the unscrupulous [fraudulent] seller."<sup>36</sup> In the *Sztejn* case the seller had literally shipped rubbish to the buyer instead of the bristles contracted for, and an injunction to prevent the bank from paying was successful.

The fraud exception to the independence principle became firmly entrenched in South Africa when the Appellate Division in another letter of credit case, *Loomcraft Fabrics CC v. Nedbank Ltd.*, stated that upon presentation of conforming documents "the bank will escape liability only upon fraud on the part of the beneficiary."<sup>37</sup> For this "established exception"<sup>38</sup> he relied on the judgment of the English House of Lords in the case *United City Merchants (Investments) Ltd. v. Royal Bank of Canada*.<sup>39</sup> In this case Lord Diplock ruled that the fraud exception arises

where the seller, for the purpose of drawing on the credit, fraudulently presents to the... bank documents that contain, expressly or by implication,

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<sup>33</sup> *Lombard Insurance*, *supra* note 31, para. 20. See further *Dormell Properties*, *supra* note 20, para. 38; *First Rand Bank Ltd. v. Brera Investments CC*, 2013 (5) S.A. 556 (S.C.A.), para. 2; *Eskom Holdings*, *supra* note 27, para. 14; *Coface*, *supra* note 20, paras. 9–13. See also *Edward Owen*, *supra* note 31, at 171A-C; *R.D. Harbottle (Mercantile) Ltd. v. National Westminster Bank Ltd.* [1977] 2 All. E.R. 862 (C.A.), at 870; *Intraco*, *supra* note 31, at 257.

<sup>34</sup> *Phillips and Another v. Standard Bank of South Africa Ltd. and others*, 1985 (3) S.A. 301 (W).

<sup>35</sup> *Sztejn v. J. Henry Schroder Banking Corporation et al.*, 31 N.Y.S.2d 631 (1941).

<sup>36</sup> *Id.* at 634.

<sup>37</sup> *Loomcraft Fabrics*, *supra* note 31, at 815J.

<sup>38</sup> *Id.* at 816A.

<sup>39</sup> *United City Merchants (Investments) Ltd. v. Royal Bank of Canada* [1983] 1 A.C. 168.

material representations of fact that to his (the seller's) knowledge are untrue.<sup>40</sup>

In this case the loading broker had falsified the date on a bill of lading without the knowledge of the seller (beneficiary of the letter of credit), and the House of Lords ruled that such third-party fraud could not prevent the innocent beneficiary from receiving payment. From the *Sztejn* and *United City Merchants* cases it is clear that the legal basis of the fraud exception in the common law jurisdictions is public policy. In *United City Merchants* Lord Diplock put it thus:

The exception for fraud on the part of the beneficiary seeking to avail himself of the credit is a clear application of the maxim *ex turpi causa non oritur actio* or, if plain English is to be preferred, "fraud unravels all." The courts will not allow their process to be used by a dishonest person to carry out a fraud.<sup>41</sup>

Lord Diplock's exposition of the fraud exception equates fraud to fraud in the documents presented by the beneficiary of which the beneficiary has knowledge. Transposed from a letter of credit to a guarantee environment, however, this approach can be problematic since documents play a significantly less prominent role in guarantees than in letters of credit. In the case of guarantees the documents consist mostly of merely a demand augmented sometimes by another document substantiating the basis of the demand (such as a notice of cancellation as in the example set out in paragraph 1.4 above). This has led to the reformulation of the fraud exception in guarantee context both in English and South African case law. In the *United Trading Corporation* case Ackner L.J. stated that it was available when it was

seriously arguable that, on the material available, the only realistic inference is that... [the beneficiary] could not honestly have believed in the validity of its demand.<sup>42</sup>

Other English cases refer to "a demand which the maker does not honestly believe to be correct",<sup>43</sup> and a claim by a beneficiary "which he knows at the time to be an invalid claim."<sup>44</sup> These renditions of fraud move away from an insistence on

<sup>40</sup> *United City Merchants*, *supra* note 39, at 183G.

<sup>41</sup> *Id.* at 183–184.

<sup>42</sup> *United Trading Corporation S.A. v. Allied Arab Bank Ltd.* [1985] 2 Lloyd's Rep. 554 (C.A.), at 561. *See also Banque Saudi Fransi v. Lear Siegler Services Inc.* [2007] 2 Lloyd's Rep. 47 (C.A.).

<sup>43</sup> *Uzinterimpex J.S.C. v. Standard Bank Plc* [2007] 2 Lloyd's Rep 187, para. 107.

<sup>44</sup> *GKN Contractors Ltd. v. Lloyd's Bank Plc* [1985] 30 B.L.R. 48, at 63.

fraud in the documents. This line of thinking has also spilt over into South Africa as is evident from the following statement by Theron J.A. in *Guardrisk Insurance Co. Ltd. v. Kentz (Pty) Ltd.*:

It is trite that where a beneficiary who makes a call on a guarantee does so with knowledge that it is not entitled to payment, our courts will step in to protect the bank and decline enforcement of the guarantee in question.<sup>45</sup>

Both the *Loomcraft* case in South Africa<sup>46</sup> and the *United City Merchants* case in England<sup>47</sup> contain dicta to the effect that beneficiary fraud constitutes the *only* exception to the independence principle. In England, however, this statement is no longer true in principle. In *Mahonia Ltd. v. JP Morgan Chase Bank*<sup>48</sup> Colman J., stressing the public policy basis of the fraud exception, recognized also the existence of an illegality exception. With reference to examples of unlawful arms transactions and unlawful heroin sales he stated:

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.<sup>49</sup>

Although the principle of an illegality exception was acknowledged in this case, the defence did not succeed ultimately since it was not proven.

Although unconscionable conduct falling short of fraud has also been recognized as an exception to independence in certain common law jurisdictions, English law has not yet recognized such an exception.<sup>50</sup> In South Africa, however, some inconclusive *obiter dicta* stressing good faith may be providing impetus towards the recognition of

<sup>45</sup> *Guardrisk Insurance Co. Ltd. and Others v. Kentz (Pty) Ltd.* [2014] 1 All S.A. 307 (S.C.A.), para. 17. See also *Scatec Solar SA 163 (Pty) Ltd. and Another v. Terrafix Suedafrika (Pty) Ltd. and Another* [2014] Z.A.W.C.H.C. 63, para. 23. For an in-depth analysis of the South African and English law in this regard see Marxen 2017, paras. 5.2.3 & 5.2.5.

<sup>46</sup> *Loomcraft Fabrics*, *supra* note 31, at 815–816.

<sup>47</sup> *United City Merchants*, *supra* note 39, at 183G.

<sup>48</sup> *Mahonia Ltd. v. JP Morgan Chase Bank* [2003] 2 Lloyd's Rep. 911 (Q.B.).

<sup>49</sup> Para. 68. For further authority in this regard see John Lurie, *On Demand Performance Bonds: Is Fraud the Only Ground for Restraining Unfair Calls?*, 25(4) *International Construction Law Review* 443, 454 *et seq.* (2008).

<sup>50</sup> Deborah Horowitz, *Letters of Credit and Demand Guarantees Defences to Payment* 129 *et seq.* (Oxford: Oxford University Press, 2010).

an unconscionability exception.<sup>51</sup> The strongest views in this regard were expressed by Jansen J. in *Sulzer Pumps (South Africa) (Proprietary) Ltd. v. Covec-MC Joint Venture*.<sup>52</sup> In this case the applicant for the guarantee sought to prevent the calling up of a guarantee by the beneficiary on the basis that the beneficiary had bound itself not to call up the guarantee in a *pactum de non petendo*. Against this background Jansen J. stated:

What the old authorities do demonstrate though, is that not only fraud may prohibit the calling up of a construction guarantee, but also *unconscionable conduct* and also when a contract to the contrary has been entered into between the relevant parties...<sup>53</sup>

Later on she concluded:

[T]he court holds that it is clear that when it is unconscionable to rely on the literal wording of a contract without reading such wording within the context of the back-ground facts, the surrounding circumstances and the purpose of the agreement, then a construction guarantee cannot be called up.<sup>54</sup>

This case, however, runs counter to a rather strong line of decisions from the Supreme Court of Appeal protecting the security of payment offered by demand guarantees.<sup>55</sup> The decision was also criticized stringently by Kelly-Louw and Marxen who termed it “not a well-reasoned judgment.”<sup>56</sup> They further state that “the ‘unconscionable’ and ‘bad faith’ exceptions have not been dealt with or even raised as a possibility in the South African case law” and that they should be avoided “as they seriously undermine the independence of demand guarantees... [and] diminish the usefulness of these instruments.”<sup>57</sup>

Before moving off the South African law one further important development needs to be considered. In the *Dormell* case<sup>58</sup> the guarantor refused to pay on a conforming

<sup>51</sup> *Group Five Construction (Pty) Ltd. and others v. Member of the Executive Council for Public Transport Roads and Works Gauteng and Others* [2015] 2 All S.A. 716 (G.J.), para. 50; *Dormell Properties*, *supra* note 20, para. 65.

<sup>52</sup> *Sulzer Pumps (South Africa) (Proprietary) Ltd. v. Covec-MC Joint Venture*, [2014] Z.A.G.P.P.H.C. 695.

<sup>53</sup> Para. 115 (my emphasis).

<sup>54</sup> Para. 125.

<sup>55</sup> See *Lombard Insurance*, *supra* note 31; *Guardrisk Insurance*, *supra* note 45; and *Coface*, *supra* note 20.

<sup>56</sup> See Michelle Kelly-Louw & Karl Marxen, *General Update on the Law of Demand Guarantees and Letters of Credit in Annual Banking Law Update* 276, 292 (C. Hugo (ed.), Cape Town: Juta, 2015).

<sup>57</sup> *Id.* at 293.

<sup>58</sup> *Supra* note 20. For more detailed analyses see Charl Hugo, *Protecting the Lifeblood of Commerce: A Critical Assessment of Recent Judgments of the South African Supreme Court of Appeal Relating to Demand Guarantees*, 4 *Journal of South African Law* 661, 663–667 (2014); *The Law of Banking and Payment in South Africa*, *supra* note 20, at 452–455.

demand presented by the beneficiary (the employer in a construction contract) raising two spurious defences that were nevertheless successful in the court a quo. The beneficiary appealed. The guarantee had been called up on the basis of an alleged breach of the underlying construction contract by the contractor (the applicant for the guarantee). By the time the case came up for consideration in the Supreme Court of Appeal, however, the dispute in the underlying construction contract had been finally determined *in favor of the contractor*. In other words, the arbitrator's award was to the effect that the contractor had not been in breach of the construction contract. Against this background the Supreme Court of Appeal had to decide whether to permit evidence on the outcome of the construction dispute.

Two of the five judges held this to be untenable on the basis of the principle of independence, since the liability of the guarantor was to be determined on the basis of the guarantee alone and disputes concerning the underlying construction contract were irrelevant. Cloete J.A., the author of the minority judgment, stated:

Once the appellant had complied with clause 5 of the guarantee [i.e. presented a conforming demand], the first respondent had no defence to a claim under the guarantee. It still has no defence. The fact that an arbitrator has determined that the appellant was not entitled to cancel the contract, binds the appellant – but only *vis-à-vis* the second respondent [the contractor]. It is *res inter alios acta* as far as the first respondent is concerned.<sup>59</sup>

The majority judgment, however, took the view that in light of the arbitral award the employer had lost the right to enforce the guarantee since “there was no legitimate purpose to which the guaranteed sum could be applied.”<sup>60</sup> Moreover, if the guarantor were ordered to pay, the contractor “would be entitled to repayment of the full amount guaranteed.”<sup>61</sup> Such an order would accordingly cause additional cost and inconvenience without practical effect, which, in terms of the Supreme Court Act<sup>62</sup> entitled the court to dismiss the appeal on that ground alone.<sup>63</sup>

The effect of the majority judgment in the *Dormell* case – although not stated expressly in these terms – was clearly that another exception to the independence principle had been recognized by the Supreme Court of Appeal: if the underlying dispute has been finally determined against the beneficiary of the guarantee

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<sup>59</sup> Para. 64.

<sup>60</sup> Paras. 40 & 41.

<sup>61</sup> Para. 42.

<sup>62</sup> Supreme Court Act 59 of 1959, sec. 21A(1). This was the legislation in force at the time of the hearing. It has since been replaced by the Superior Courts Act 10 of 2013, sec. 16(2) of which is comparable.

<sup>63</sup> Para. 45.

in arbitration (or litigation) this would provide a defence against liability on the guarantee, or the basis for an injunction preventing payment thereof.

However, it soon became clear in *obiter dicta* emanating from the Supreme Court of Appeal in subsequent cases that other judges of the Supreme Court of Appeal were not comfortable with the majority decision in *Dormell*.<sup>64</sup> Eventually, in the *Coface* case, the Court held that the minority judgment in *Dormell* had got it right and that the majority judgment was clearly wrong.<sup>65</sup> *Dormell* was overturned with the following motivation:

Since the decision in *Dormell*, and perhaps predictably, there has been an increasing number of cases in which guaranteeing banks have sought to introduce contractual disputes in order to avoid meeting the guarantee. In some cases the allegedly defaulting contractor sought to join the fray. It is the very consequence that the line of cases prior to *Dormell* sought to avoid.<sup>66</sup>

Since *Coface*, therefore, the South African law will not allow the prior determination of the underlying dispute to form a defence or basis to interdict payment.

In the light of the aforementioned it is clear that the jurisprudence relating to the independence of guarantees and the exceptions in this regard is a constantly developing area,<sup>67</sup> which has led one commentator to conclude that

[c]ontractors should take comfort that the law governing on-demand performance bonds is becoming more heavily infused with concepts of fairness and equity.<sup>68</sup>

### 3. Chinese Law

#### **3.1. Introduction: Sources of the Chinese Law of Contract**

Ancient and early Chinese law, according to Bing Ling, “failed to develop a civil law tradition comparable to Roman law” but that it nevertheless contained “sophisticated

<sup>64</sup> See *First Rand*, *supra* note 33, at 561F–562G; *Guardrisk Insurance*, *supra* note 45, paras. 22–25.

<sup>65</sup> *Dormell Properties*, *supra* note 20, para. 25.

<sup>66</sup> Para. 24.

<sup>67</sup> In her impressive treatise on the defences to payment Horowitz 2010, at 14 (and at the conclusion of each chapter) works with a “spectrum of abstraction” moving from the “most abstract” to the “least abstract” (or from “autonomy” to “interdependence”). The different potential defences are plotted on the spectrum either to the left or right of an “ideal cut-off point” which determines whether or not the defence should be recognized. Her spectrum (or model) provides for development in that it is not fixed but “movable for policy.”

<sup>68</sup> Lurie 2008, at 465. The infusion with concepts of fairness and equity is also evident English law from the prominence placed on “bad faith” or a “lack of good faith” in this context in *TTI Team Telecom International Ltd. & Anor v. Hutchison 3G UK Ltd.* [2003] E.W.H.C. 762 (T.C.C.), para. 31.



rules and procedures on private contract” which were for the most part embodied in “conventional rites... and customs.”<sup>69</sup> In due course the application of law to contractual disputes was influenced by “Confucian ethos and public mores.”<sup>70</sup> The modernization of contract law commenced in the early 20<sup>th</sup> century in the form of, first, two draft civil codes, and, eventually, after the proclamation of the Republic of China (ROC) in 1912, the promulgation of the ROC Civil Code in 1929. This first modern civil code in Chinese history contained five books dealing respectively with general principles, obligations, real rights, family and succession. It was significantly influenced by the German and Swiss codes. It transplanted many concepts and doctrines of European civil law into China but also placed strong emphasis on public interest and good faith.<sup>71</sup>

With the advent of communism in 1949 the ROC Civil Code was abolished. During the ensuing period three contract laws<sup>72</sup> were enacted, namely, the Economic Contract Law (ECL) in 1981; the Foreign Economic Contract Law (FECL) in 1985; and the Technology Contract Law (TCL) in 1987.<sup>73</sup> The ECL, which governed contracts between Chinese parties, was, according to Bing Ling “mostly general and crude and fail[ed] to include many important concepts and principles of modern contract law.”<sup>74</sup> State control and governmental supervision emerge strongly from it. As China adopted an “opening up” policy the need for regulation of economic contracts with foreigners emerged. This resulted in the enactment of the FECL, which was largely modelled on foreign and international laws on commercial contracts and placed more emphasis on party autonomy (less governmental interference).<sup>75</sup> Moreover, a comprehensive code, the General Provisions of Civil Law (GPCL), was passed in 1986. In relation to the GPCL Bing Ling remarks:

The legislature aimed not to achieve German-style scientific elegance, but rather to serve indigenous pragmatism, namely to enact such basic provisions of law that would meet the demand of a society that was moving towards market economy and civil society. <...> Although the GPLC fails to provide for a comprehensive regime on contract, it spells out certain fundamental concepts and principles of modern civil law and thus lays down the conceptual

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<sup>69</sup> Bing Ling, *Contract Law in China* 9 (Hong Kong: Sweet & Maxwell Asia, 2002).

<sup>70</sup> *Id.* See also on the role of Confucianism Junwei Fu, *Modern European Chinese Contract Law: A Comparative Study of Party Autonomy* xvii, 9–13 (Alphen aan den Rijn: Kluwer Law International, 2011).

<sup>71</sup> Ling 2002, at 10. It is still in force in Taiwan today. See in this regard Fu 2011, at xviii.

<sup>72</sup> “Law” is used here in the context of statutory law.

<sup>73</sup> Ling 2002, at 11–14; Fu 2011, at xviii, 2.

<sup>74</sup> Ling 2002, at 12.

<sup>75</sup> *Id.* at 12–13.

and doctrinal foundation upon which further civil and commercial legislation can be built. In substance the GPCL also developed a marked departure from the dominance of the state plan and governmental intervention and placed a new emphasis on private autonomy.<sup>76</sup>

By the early 1990s economic reform towards a market economy was a reality. Much of the ECL was incompatible with this situation. This led to amendments of the ECL in 1993 which were relatively modest since, by that time, the legislature had decided that all major changes should be done by way of a new unified contract law,<sup>77</sup> which eventually come into effect in October 1999 as the Contract Law (CLC). The ECL and FECL were repealed at the same time. Junwei Fu remarks as follows regarding the CLC:

The CLC is designed to reflect contemporary Chinese social and economic life. While it mirrors the current economic and globalizing developments, it reveals the limited freedom or autonomy in Chinese social life. In other words, the CLC reflects tensions between the imperatives of state control and individual freedom.<sup>78</sup>

Regarding the practical interaction between the CLC and the GPCL the position is that contractual disputes are adjudicated primarily with reference to the CLC. However, if the CLC does not deal with the matter the courts will revert to the GPLC.<sup>79</sup> It should further be noted that the CLC is a general law dealing with contracts. Apart from it the Chinese legislature has enacted several specialized laws dealing with specific contracts.<sup>80</sup> One such law is the Security Law which applies to guarantees.<sup>81</sup> In the event of a conflict between provisions of the CLC and any such special law, provisions of the special law prevail.<sup>82</sup>

Regarding the general principles of contract law in China it is important to highlight the central role of fairness and good faith. Article 5 of the CLC provides:

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<sup>76</sup> Ling 2002, at 13.

<sup>77</sup> *Id.* at 14.

<sup>78</sup> Fu 2011, at 2.

<sup>79</sup> *Id.*

<sup>80</sup> Ling 2002, at 26–28.

<sup>81</sup> *Id.* at 26.

<sup>82</sup> Article 123 of the CLC provides: "Where other laws have other provisions for contracts, those provisions shall govern." See, in this regard, Ling 2002, at 27–28 who also makes the point that this rule is based on the principle that the more specialised law is stronger than the more general law, and, for this reason, that Article 123 does not apply to a conflict between the CLC and the (more general) GPLC.

The parties shall observe the principle of fairness in determining their respective rights and duties

and Article 6:

The parties shall observe the principle of good faith in the exercise of their rights and the performance of their duties.

Fairness is seen as derived from good faith.<sup>83</sup> Any detailed discussion on the role of fairness and good faith falls outside the scope of this article. However, it is important to stress that these principles, which some trace back to Confucianism, are fundamentally important in Chinese law. Bing Ling terms good faith “indeed one of the... fundamental principles that form the doctrinal bases for the specific principles and rules in the Contract Law.”<sup>84</sup> Fairness, in turn, “requires that the parties follow generally accepted moral, social and commercial standards and keep to a reasonable balance of interests in the transaction.”<sup>85</sup> It is clear that the combination of good faith and fairness in Chinese law entails, *inter alia*, that powers and rights should not be abused.<sup>86</sup>

As evident from this brief background the interpretation of Chinese contract law can be problematic, and, in the words of Bing Ling, is a matter “that has received inadequate treatment in Chinese law.”<sup>87</sup> One of the methods by which problems of interpretation is dealt with in Chinese law is by so-called Judicial Interpretation. This, as emerges clearly below, is an aspect of particular importance for the purposes of this article. The Supreme People’s Court (SPC) of China is empowered to interpret laws in the course of their concrete application in adjudication. Although the power conferred to the Supreme People’s Court (SPC) clearly referred to cases of concrete application, the SPC, as Bing Ling puts it “has gone far beyond the limit and has performed interpretation that should be more properly described as ‘quasi legislation.’” He then continues as follows:

As the SPC has taken an active role in judicial interpretation, judicial interpretation is now a major part of *primary sources* of Chinese law. In practice, many judicial interpretations contain comprehensive provisions

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<sup>83</sup> Ling 2002, at 50.

<sup>84</sup> *Id.* at 52. See also Fu 2011, at 46 who terms it a “significantly important principle” without equating it to the “highest guiding principle for the law of obligations” which prevails in many civil law countries.

<sup>85</sup> Ling 2002, at 50.

<sup>86</sup> Ling 2002, at 51; Fu 2011, at 44.

<sup>87</sup> Ling 2002, at 26.

that interpret or supplement the provisions of a particular law or deal with particular types of issues.<sup>88</sup>

A judicial interpretation dealing with independent guarantees, *Provisions of the Supreme People's Court of the People's Republic of China on Several Issues Concerning the Trial of Disputes Over Independent Guarantees* (henceforth: *IGP* for “*Independent Guarantee Provisions*”) was released in a meeting of the Judicial Committee of the Supreme People's Court on 7 July 2016 and came into effect on 1 December 2016.<sup>89</sup> The English translation of the introductory clause of the *IGP* reads:

For the purpose of proper adjudication of independent guarantee dispute cases, maintaining the legal rights and interests of the parties, servicing and safeguarding the “Belt and Road Initiatives,” and promoting the Opening-up Policy, these Judicial Provisions are formulated in accordance with General Principles of the Civil Law of the People's Republic of China [the GPCL], Contract Law of the People's Republic of China [the CLC], Security Law of the People's Republic of China, Law of the Application of Law for Foreign-related Civil Relations of the People's Republic of China, Civil Procedure Law of the People's Republic of China and other laws, and in light of the adjudication practices: <...>

The purpose of the *IGP* emerges from this clause. Some of its provisions to which I turn below are of particular importance for the purposes of this article.

### **3.2. Independent (Demand) Guarantees and Accessory Guarantees Distinguished**

Article 3<sup>90</sup> of the *IGP* provides that a court will support a party's claim that a guarantee is independent if the guarantee meets any one or more of three different requirements. They are:

<sup>88</sup> Ling 2002, at 32 (my emphasis).

<sup>89</sup> *LC Rules & Laws: Critical Texts for Independent Undertakings* 317 *et seq.* (J.E. Byrne (ed.), 7<sup>th</sup> ed., Montgomery Village: Institute of International Banking Law & Practice, Inc., 2018). The translation was prepared by a team headed by Jin Saibo of the Beijing Jincheng Tongda & Neal law firm who was assisted by Feng Jing, Hong Qin, and Zhang Zheng. The English translation was reviewed by Prof James Byrne with the assistance of Justin Berger, Karl Marxen and Yangjun “Anora” Wang (see, in this regard, the “Editor's Overview” 317–318 of this work). The *IGP* is also available as a separate publication containing annotations: IIBLP, *Independent Guarantee Provisions of the PRC Supreme People's Court – Annotated English Translation* (2017). An earlier draft of the *IGP* had already been released in December 2013. See in this regard Ningning Zhang, *Abuse: An Exception to Payment Under Independent Guarantees in China*, 26 *International Company and Commercial Law Review* 265, 266 (2015). It differs, however, in many respects from the final *IGP* and is disregarded in the remainder of this article.

<sup>90</sup> The English translation contains headings which are absent in the original Chinese since such headings would apparently be inconsistent with other judicial interpretations. They were added to the translated text “[f]or the convenience of the reader.” The heading of Article 3 is “Independence.” See *LC Rules & Laws*, *supra* note 89, at 318 note 5.

(i) the guarantee itself “states that it is payable on demand”;

(ii) the guarantee states “that it is subject to the ICC Uniform Rules for Demand Guarantees or other model rules for independent guarantee transactions”;<sup>91</sup> and

(iii) “based on the text of the Guarantee, the Issuer’s payment obligation is independent from the underlying transaction relationship or guarantee application relationship, and the Issuer is liable for payment only against a complying presentation.”

However, there is a proviso applicable to all three namely that the guarantee must “specify any document against which the payment shall be made” and “the maximum amount payable.” Article 3 then provides that a party’s claim that the nature of the guarantee is that of “a general guarantee or a guarantee with joint and several liability” due to the fact that the guarantee refers to the relevant underlying transaction, “shall not be supported by a People’s Court.” The article then concludes by providing emphatically that the People’s Court will not entertain a claim by a party that a guarantee meeting the requirements of an independent guarantee as set out above, should be adjudicated with reference to the rules of the Security Law. Hence, the Security Law referred to in paragraph 3.1 above, regulates accessory guarantees (or, to use the words of the translators, “general guarantees” or “guarantees with joint and several liability”), and not independent guarantees, which, by implication, are to be dealt with in accordance with the provisions of the *IGP*.

### **3.3. Independence and Exceptions to Independence**

The independence of demand guarantees and the exceptions to this independence are dealt with in detail in the *IGP*. First, the independence principle is set out as follows in Article 6:

The Issuer may not seek to excuse its payment obligation based on defenses arising out of the underlying transaction relationship or the independent Guarantee’s relationship with the Applicant and such defenses shall not be supported by a People’s Court, except under the circumstances provided in Article 12 [*Fraud*] of these Judicial Provisions.

Article 12 of the *IGP* then states a number of exceptions to independence which are lumped together under the generic term “independent guarantee fraud.” The article reads as follows:

Independent guarantee fraud shall be found by a People’s Court under one of the following circumstances:

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<sup>91</sup> It is suggested that the term “other model rules” here refers primarily to the *ISP 98* and the UNCITRAL Convention, on which see para. 1.2 *supra*.

- (1) The Beneficiary, acting in collusion with the Guarantee Applicant or any other party, has fabricated the underlying transaction;
- (2) Any of the third-party documents presented by the Beneficiary is forged or contains false information;
- (3) Any court judgment or arbitral award finds that the party obligated on the underlying transaction shall not be liable for payment or damages;
- (4) The Beneficiary acknowledges that the obligations under the underlying transaction have been fully discharged or that the payment triggering event specified in the Independent Guarantee has not occurred; or
- (5) The Beneficiary otherwise knowingly abuses its right to demand payment when it has no such right.

The procedural aspects of disputes relating to “independent guarantee fraud” are subsequently dealt with in Article 13 which reads as follows:

The Applicant, the Issuer, or the Instructing Party of the Independent Guarantee may, prior to or during the court litigation or arbitral procedure, file a petition with a People’s Court of the Issuer’s domicile or any other People’s Court with competent jurisdiction over the Independent Guarantee fraud dispute to suspend the payment under the Independent Guarantee in the event they find out that any of the circumstances provided in Article 12 [*Fraud*] has occurred.

Finally, Article 14 of the *IGP* goes on to set three requirements, all of which must be met, before a People’s Court will be willing to grant a ruling suspending payment in terms of Article 13. They are stated as follows:

- (1) The evidence filed by the petitioner for payment suspension supports a high probability of existence of any of the circumstances provided in Article 12 [*Fraud*];
- (2) It is under such urgent circumstances that the petitioner’s lawful rights and interests will suffer irreparable damage if payment is not suspended; and
- (3) The petitioner has provided security sufficient to cover the damage probably caused by the payment suspension to the party(ies) against whom the application is made.

Article 14 further provides that suspension will not be ordered on the basis of breach of contract on the part of the beneficiary. This simply reinforces the independence principle. Finally it provides that where an issuing guarantor has paid a guarantee in good faith, a court will not suspend payment under another independent guarantee intended “to secure the Issuer’s right to reimbursement.” This provision simply reinforces the independence of the backing guarantee.

## 4. Comparative Analysis

### 4.1. Determining Whether a Guarantee Is Independent or Accessory

In accordance with South African law, this question requires interpretation of the guarantee as a whole in order to determine the intention of the parties. Against this background, should the guarantee contain terms indicative of accessory, the South African courts (irrespective of the fact that other terms may indicate independence) have little difficulty in finding the guarantee to be accessory.<sup>92</sup> The Chinese *IGP*, on the other hand, adopts more of a rule-based approach in terms of which a guarantee is to be regarded as independent if it meets any one of three requirements. One of these is that “based on the text of the Guarantee, the Issuer’s payment obligation is independent from the underlying transaction relationship or guarantee application relationship, and the Issuer is liable for payment only against a complying presentation.”<sup>93</sup> This requirement, it is suggested, is a reasonably accurate reflection of the South African law.

However, the *IGP* add two further bases upon which a court will find the guarantee to be independent, which, from a South African perspective may be a bit more problematic. The first is if the guarantee incorporates the *URDG* or other independent guarantee rules.<sup>94</sup> Since the incorporation of such rules must be a very strong indication of an intention by the parties that the guarantee should be independent, in practice it would be most unusual that such a guarantee will be found to be accessory by a South African court. However, it is not impossible should the guarantee incorporating the *URDG* nevertheless contain a specific term clearly indicative of an intention of accessory.

The second is if the guarantee states that it is payable on demand.<sup>95</sup> This is more problematic. In the *KNS Construction* case, for example, the guarantor’s undertaking was indeed to pay “on receipt of a written demand,”<sup>96</sup> yet the court found the guarantee to be accessory on the basis of other indications in it to this effect.

In my view the South African approach is the better one. Leaving that aside, the important fact to note is that some guarantees that may be found to be accessory in South African law, may indeed be considered as independent by a court or tribunal applying Chinese law. Kelly-Louw’s view that accessory is the default position,<sup>97</sup> cannot in my view be regarded as true for Chinese law under the *IGP*.<sup>98</sup>

<sup>92</sup> See para. 2.2 *supra*.

<sup>93</sup> See para. 3.2 *supra*.

<sup>94</sup> *Id.*

<sup>95</sup> *Id.*

<sup>96</sup> *Supra* note 26. See clause 3 of the guarantee quoted in paragraph 2 of the judgment.

<sup>97</sup> See para. 2.2 *supra*.

<sup>98</sup> It is of interest to note that, according to Zhang 2014, at 115–116, prior to the *IGP* “the relevant rules stated by the Chinese authorities create[d] a presumption that the guarantee is ancillary [accessory].” It is suggested that if this is correct, the *IGP* has changed matters fundamentally.

#### **4.2. Independence and Exceptions to Independence**

It is in the area of the independence principle, and, more particularly, the recognized exceptions to this principle, that South African and Chinese law differ significantly. The differences are not to be found in the meaning of independence (as stated in Article 6 of the *IGP*), or in the procedural and evidentiary rules (as set out in Articles 13 and 14 of the *IGP*), which, viewed generally, correspond reasonably well to the South African law in this regard.<sup>99</sup> However, the two systems differ significantly in relation to the exceptions recognized by them.

As mentioned above, the exceptions are grouped together in the *IGP* under the umbrella term “independent guarantee fraud.” However, on reading Article 12 it becomes abundantly clear that this “fraud” has a much wider ambit than fraud in South Africa. The English translators, in an annotation to the *IGP*, state that it encompasses “fraudulent activity in relation to an Independent Guarantee seeking to take improper advantage of the independence and documentary nature of an Independent Guarantee.”<sup>100</sup> Five such activities are then listed in Article 12 which need to be considered closely.

The first, namely that the beneficiary fabricates the underlying transaction in collusion with another, would in my view also constitute fraud in South African law. It is clearly conduct by the beneficiary aimed at acquiring payment under a guarantee in the knowledge of not being entitled thereto. As such it falls squarely within the test for fraud formulated by the Supreme Court of Appeal in the *Guardrisk* case as set out above.<sup>101</sup>

However, the second of the listed activities, namely the presentation by the beneficiary of a third-party document that is forged or contains false information, is more problematic. There is no indication that the beneficiary must have knowledge of the forgery or falsity. As stated above, the South African law requires such knowledge. Third-party fraud is not recognized as fraud and cannot provide either the basis for a defence on the part of the guarantor against the beneficiary’s claim, or a basis for interdicting payment.<sup>102</sup> Although the presentation of third-party documents is not all that prevalent in guarantee practice, it is not unknown. The implication of the *IGP*

<sup>99</sup> Procedurally the issue can arise in three distinct manners in South African law. The guarantor can refuse to pay, and if sued raise the fraud defence. This is in harmony with Article 6 of the *IGP* which, by implication, allows the issuer “to excuse its payment obligation... under the circumstances provided in Article 12.” Article 14 of the *IGP*, in turn, relates well to the South African law of interlocutory interdicts. See in this regard D.E. van Loggerenberg, *Erasmus Superior Court Practice. Vol 2 Appendix D6* (Cape Town: Juta, 2015); Stephen Peté et al., *Civil Procedure: A Practical Guide 440 et seq.* (3<sup>rd</sup> ed., Oxford: Oxford University Press, 2008).

<sup>100</sup> IIBLP, *supra* note 89, at 7 note 19.

<sup>101</sup> See para. 2.3 *supra*, and especially the text at note 45.

<sup>102</sup> See para. 2.3 *supra*, and especially the discussion of the *United City Merchants* case in the text at note 40 *et seq.*



rule is that, for example, if an employer in a construction contract, in order to avail itself of a construction guarantee, must provide a certificate by an expert engineer indicating that the contractor's performance does not meet certain requirements, and the employer does so without knowledge of the fact that the engineer has made a false statement, the contractor, on the basis of independent guarantee fraud, is able to interdict payment under Chinese law. This would not be the case under South African law.

The third of the listed activities, namely that a court or arbitrator has found that the party whose performance was guaranteed is not liable for payment or damages, is likewise problematic from a South African legal perspective, as is evident from the vicissitudes of *Dormell* judgment<sup>103</sup> in South Africa. As described above the South African Supreme Court of Appeal, in the *Coface* case,<sup>104</sup> overruled the majority judgment in the *Dormell* case which was largely in harmony with this (third) listed activity in Article 12 of the *IGP*. Post *Coface*, therefore, a judgment or arbitral award on the dispute on the underlying contract is regarded as irrelevant due to the independence of the guarantee in South African law.

The fourth of the listed activities is a demand for payment despite an acknowledgement by the beneficiary that the underlying obligations have been discharged or that the event triggering payment under the guarantee has not occurred. Such conduct does not fit neatly into the category of a recognized exception or no exception. On the one hand one can argue that a beneficiary who has acknowledged that the underlying obligations have been discharged or that the triggering event has not occurred, and nevertheless calls up the guarantee, will probably meet the *Guardrisk* test of seeking payment under a guarantee in the knowledge of not being entitled thereto. This would constitute fraud. On the other hand, the judgment in the *Coface* case may be interpreted as providing authority to the contrary. In this case the guarantor applied to amend its pleadings so as to reflect that the beneficiary (employer) had demanded payment of a construction guarantee despite the fact that a payment certificate issued by the agent of the beneficiary, which the guarantor contended was to be regarded as a final payment certificate, reflected a nil balance owing to the beneficiary.<sup>105</sup> The court took the view that such a defence was untenable due to the independence of the guarantee and the amendment was disallowed.<sup>106</sup> In my view, in this type of situation, the facts of each case must be scrutinized carefully in order to determine whether the conduct of the beneficiary meets the test for fraud in South African law. It is suggested that the contents of a payment certificate may be valuable evidence to be considered

<sup>103</sup> See para. 2.3 *supra* (especially the text at note 58 *et seq.*).

<sup>104</sup> See para. 2.3 *supra* (especially the text at note 65 *et seq.*).

<sup>105</sup> *Coface*, *supra* note 20, para. 6.

<sup>106</sup> Paras. 9–26.

when testing for fraud. In any event, against the background of *Coface*, it cannot currently be said that the fourth listed activity constitutes a recognized exception to the independence principle in South African law.

The final listed activity refers to a beneficiary who in some other way “knowingly abuses its right to demand payment.”<sup>107</sup> This is clearly a catch-all final provision intended to provide for other situations not previously listed.<sup>108</sup> Essentially, it adopts the abuse of rights doctrine (the *Rechtsmissbrauch* of German law)<sup>109</sup> which, in harmony with the importance of good faith and fairness in the Chinese law of contract,<sup>110</sup> forms part of Chinese law.<sup>111</sup> It is suggested that this final listed activity probably includes both the illegality exception and the unconscionability exception (to use the legal terminology employed in this regard in South African and common law legal literature).

Despite its civilian roots, however, South African law does not recognize the abuse of rights doctrine (the roots of which lie in the dominant principle of good faith in the law of contract<sup>112</sup>). The role of good faith does emerge in various contexts in the South African law of contract, but is nevertheless not as prominent as in German or Chinese law. The battle regarding the role of good faith in South Africa is typically fought on the competing principles of *pacta sunt servanda* and fairness. In the pre-constitutional era, the highest South African court came out strongly on the side of *pacta sunt servanda*.<sup>113</sup> In the constitutional era, there are signs that this may be changing, but not quickly or boldly. In *Brisley v. Drotzky* the majority of the Supreme Court of Appeal, in a split decision, put it thus:

[22] Regarding the role of good faith we agree in essence with the view... that good faith is not an independent, or “free floating” basis for the... non application of contractual terms. Good faith is a fundamental principle that

<sup>107</sup> The description unfortunately does not stop there. It continues “...when it has no such right.” This creates a bit of a semantic nightmare since one can hardly abuse a right that you do not have. Nevertheless, as further argued in the text above, the intention appears to be to apply the “abuse of rights” doctrine.

<sup>108</sup> One such may well be illegality of the underlying contract – a notion that has found recognition in English law. See the discussion of the *Mahonia* case, *supra* para. 2.3. For detailed discussions of this aspect see Michelle Kelly-Louw, *Illegality as an Exception to the Autonomy Principle of Bank Demand Guarantees*, 42(3) Comparative and International Law Journal of Southern Africa 339 (2009); Marxen 2017, para. 5.4.

<sup>109</sup> See in this regard Marxen 2017, chapter 5 *passim* where he discusses the doctrine in various contexts.

<sup>110</sup> See para. 3.1 *supra*.

<sup>111</sup> See Zhang 2015, at 270: “abuse refers to the improper exercise of one’s rights in a manner that produces harm or loss to someone else. It could give rise to an exception to payment under independent guarantees in Chinese judicial practice.”

<sup>112</sup> See Marxen 2017, para. 5.2.9.

<sup>113</sup> *Sentrale Ko-op Graanmaatskappy Bpk v. Shifren en Andere*, 1964 (4) S.A. 760 (A).

underlies the law of contract in general and finds expression in specific rules and principles thereof.<sup>114</sup>

The court then went on to refer with approval to the views of Hutchison<sup>115</sup> to the effect that good faith “may be regarded as an ethical value or controlling principle based on community standards of decency and fairness that underlies and informs the substantive law of contract” and that it thus “has a creative, a controlling and a legitimating or explanatory function.” The following dictum from the minority judgment of Olivier J.A. is also noteworthy:

[R]easonableness and equity in the form of *bona fides* has become more prominent. It is clear that our law is in a phase of development where *contractual justice* has emerged stronger than ever before as a moral and juridical norm. This tendency will in all probability... be strengthened by constitutional values.<sup>116</sup>

This *dictum* was prophetic. In *Barkhuizen v. Napier*<sup>117</sup> the Constitutional Court had the opportunity to deal with the tension between *pacta sunt servanda* and “[n]otions of fairness, justice and equity, and reasonableness,” which the Court held “cannot be separated from public policy,” which, in turn, must take into account “the necessity to do simple justice between individuals” and “is informed by the concept of ubuntu.”<sup>118</sup> Some five years later (in 2012) the Constitutional Court gave the following guidance and direction to the role of good faith in the South African law of contract:

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<sup>114</sup> *Brisley v. Drotzky*, 2002 (4) S.A. 1 (S.C.A.), at 15. The judgment was in Afrikaans. The English translation in the text is my own. The original reads as follows: “Wat die rol van goeie trou betref, stem ons in wese saam met die siening... waarvolgens goeie trou nie ’n onafhanklike, oftewel “free floating,” basis vir die... nie-toepassing van kontraktuele bepalings bied nie. Goeie trou is ’n grondbeginsel wat in die algemeen onderliggend is aan die kontraktereg en wat uiting vind in die besondere reëls en beginsels daarvan.”

<sup>115</sup> Dale Hutchison, *Non-Variation Clauses in Contract: Any Escape from the Shifren Straitjacket?*, 118 South African Law Journal 720, 744 (2001).

<sup>116</sup> Para. 25. The English translation is mine. The original Afrikaans reads: “[R]edelikheid en billikheid in die vorm van die *bona fides* [het] al hoe meer op die voorgrond getree. Dit is duidelik dat ons reg in ’n ontwikkelingsfase is waar *kontraktuele geregtigheid* meer as ooit tevore as ’n morele en juridiese norm van groot belang op die voorgrond tree. Hierdie tendens sal na alle waarskynlikheid... deur grondwetlike waardes versterk word.”

<sup>117</sup> *Barkhuizen v. Napier*, 2007 (5) S.A. 323 (C.C.), para. 51.

<sup>118</sup> “Ubuntu” is an important concept in African life. T.W. Bennett, *Ubuntu: An African Jurisprudence* 1 (Cape Town: Juta, 2018) quotes the following definition ascribed to Drucilla Cornell, *Law and Revolution in South Africa: Ubuntu, Dignity, and the Struggle for Constitutional Transformation* 40 (New York: Fordham University Press, 2014): “[Ubuntu is] an activist ethic of virtue in which what it means to be a human being is ethically performed, on a day-to-day basis, in a context in which how we are supposed to live together is constantly evoked and at the same time called into question.”

Good faith is a matter of considerable importance in our contract law and the extent to which our courts enforce the good faith requirement in contract law is a matter of considerable public and constitutional importance. The question whether the spirit, purport and objects of the Constitution require courts to encourage good faith in contractual dealings and whether our Constitution insists that good faith requirements are enforceable should be determined sooner rather than later. Many people enter into contracts daily and every contract has the potential not to be performed in good faith. The issue of good faith in contract touches the lives of many ordinary people in our country.<sup>119</sup>

Whether this means that our courts, in the wake of a growing importance of good faith in the South African law of contract, will become more open towards exceptions to independence in the law of guarantees remains to be seen. I am inclined to the view that the answer is “yes.”

### Conclusion

There are significant differences between the Chinese and South African law relating to independent guarantees. These differences relate first to the determination whether a guarantee is accessory or independent, and, secondly, to the strength of the independence (in the case of an independent guarantee). The approach of the two legal systems to these issues can be explained with reference to fundamental tenets of the law of contract in the two countries. In this respect it is of interest to note that the South African law of contract appears to be developing towards a greater recognition of good faith, which, in relation to the recognition of exceptions to the independence principle, may bring it closer to Chinese law. For the time being, however, it is important for guarantee practitioners and lawyers of both countries to understand the current differences between the two systems, and to align their guarantee practice accordingly.

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<sup>119</sup> *Everfresh Market Virginia (Pty) Ltd. v. Shoprite Checkers (Pty) Ltd.*, 2012 (1) S.A. 256 (C.C.), para. 22. On this development in South African law see also Karl Marxen & Charl Hugo, *Exceptions to the Independence of Autonomous Instruments of Payment and Security: The Growing Emergence of Good Faith in Transnational Impacts on Law: Perspectives from South Africa and Germany* 131 (C. Hugo & T.M.J. Möllers (eds.), Baden-Baden: Nomos, 2017).

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