BANK SURETYSHIPS AND BANK GUARANTEES IN FOREIGN TRADE

Professor E. Von Caemmerer was a Visiting Professor at Victoria University of Wellington in the Autumn of 1976. The following article is in substance the text of a lecture delivered by him in the Law Faculty during that visit.

Bank suretyships and bank guarantees play an important role in foreign trade. And, at the same time, suretyship transactions are an important part of the business of European banks. If one asks the question which transactions the banks in Europe use for payment and payment security in foreign trade, letters of credit and bank guarantees stand in the foreground.

Let me give several examples of the use of bank guarantees. Firstly, importers want to secure from the customs officials a postponement in the due date of customs, and they may receive this against the establishment of a bank suretyship. Secondly, business concerns solicit orders for large scale construction projects and participate in the relevant bidding; in order to do this they must place a tender guarantee. Thirdly, with respect to contracts which are to be closed across national borders, such as delivery contracts or contracts for the construction of plants, the deliverer or producer must provide repayment guarantees and performance guarantees.

In all of these cases bank sureties or bank guarantees are used.

I. Bank Guarantees As Credit Transactions

A bank which stands surety or undertakes guarantees for its customers, thereby provides the customers with credit. Obviously one must look more carefully here at what is meant by the provision of credit. By the provision of credit, one can from an economic standpoint and from a legal standpoint understand two quite different things. It seems to me to be useful to expand this point somewhat.

In Germany one distinguishes in banking law literature between effective provision of credit on the one hand and a provision of credit through simple assumption of liability on the other. In the latter case one speaks of *Kreditleihe* (lending of credit).

Correspondingly, the French banking law literature distinguishes between *credit par caisse* and simple *credit par signature.*

Also in English usage one can probably distinguish between effective provision of credit and the case where the bank "only lends its name".

Effective provision of credit exists when a credit sum is placed at one's disposal or when claims are postponed. In legal terms, the effective provision of credit can thus appear in various forms. In the foreground stands the loan, that is the provision of a cash credit through a bank. The provision of credit also includes, however, the delivery of goods with postponement of payment. One speaks here of commercial credit or trade credit. Every performance in conjunction with postponement of the corresponding performance and every advance payment or advance performance constitutes the provision of credit. The recipient of credit receives effective purchasing power. It is given to him for a period of time, and after the credit term he must pay it back.

In contrast to these cases of effective provision of credit, there are the cases of simple assumption of liability. The bank does not put effective purchasing power at the disposal of the customer, rather it establishes a contingent liability. The bank extends to its customers its credit, in the sense of creditworthiness — that is, the credit which it enjoys. Supported by the credit of the bank which stands behind him, the customer can then in other ways secure effective credit in the form of commercial credit, instalment credit, customs or freight postponement and so forth. The bank makes that possible for him by vouching for him. Normally, if the transaction is carried out as expected, a claim under the guarantee and thereby an expenditure of its own means by the bank does not occur.

The most important cases of provision of credit of this kind are the acceptance credit (*Akzepskredit* in German) and the suretyship credit (*Avalkredit* in German).

The function of this suretyship credit, in which the bank simply undertakes a contingent liability, lies in an appropriate division of functions. Let me attempt to explain by reference to the example of a postponement of the duty to pay customs on the basis of a bank guarantee. The government customs office is prepared to postpone for the importer the requirement to pay customs duties on the imported goods and in this way to provide him with effective credit. But the customs official is not a banker and cannot involve himself in checking the creditworthiness of importers or checking the security for this provision of credit against the conveyance of the merchandise or the assignment of accounts receivable. The customs office is not in a position to check or to supervise securities. This is rather the calling of the banker. The bank which stands surety for customs' obligations provides for possible recourse against its customers through appropriate security measures. It thus makes its possible for its customer to receive this effective credit from the customs office. It bears the potential risk that its customer will not pay the debt in due course, that after expiration of the tax-postponement period the customer will not be able to tender payment. The bank can accept this risk however, for on the basis of its business relationship with its client it knows his solvency and can judge the value of securities which he has given to the bank.

II. Important Cases of Bank Guarantees in Foreign Trade

A. Tender Guarantee

An exporter or manufacturing company which wants to participate in foreign competitive bidding must very frequently provide a bank guarantee of a particular amount to the person who called for the tender. Through this bank guarantee it is sought to ensure that the firm will not withdraw its offer if it is awarded the contract. The person who calls for tenders wants to be sure that the effort and cost which is associated with the processing of offers from various countries is not in the end for nothing and that the entire proceedings need not be repeated because the firm which won the contract is not ready to carry it out. The tender guarantee is to protect the beneficiary against the damages which he would suffer through the withdrawal of the offer. Important among these damages is the fact that the other participants in the competition are no longer bound to their earlier offers once the contract is awarded to one of the firms. Such tender guarantees, which are generally to be measured on the basis of a fixed sum of money (usually for an amount of about five to ten percent of the value of the commission), play an especially important role where governmental bodies let the bids.

B. Performance Guarantees

If the buyer or orderer wants security that the deliverer or manufacturer will fulfil his obligations according to schedule and without defect, he should demand a performance guarantee. It is normally measured at ten or twenty percent of the amount of the contract and is to give the buyer or orderer security that the seller will duly pay possible damage claims resulting from delayed or defective delivery.

C. Re-payment Guarantees

If a shipping company orders the building of a fishing vessel or a tanker in a foreign shipyard, or if the building of a factory is given to a foreign contractor, it is agreed as a rule that the orderer has to pay specific amounts corresponding to the progress of the work. Thus the orderer wants to be sure that he receives his instalments back if the ship is not completed or if the factory is not finished. In this case the shipyard or contractor must give a bank guarantee in the amount of the paid instalments, and such a guarantee is called a re-payment guarantee.

Tender guarantees, performance guarantees and re-payment guarantees are probably the most important guarantees or suretyships which are provided by banks in foreign trade or in the performance of work across national borders.

In the anglo-american jurisdictions banks give letters of credit for the same purposes because suretyships or guarantees could be deemed ultra vires. Such guarantee-letters of credit should be distinguished

from letters of credit given in connection with documentary credits as they do not involve any documentary transaction. The content of the obligations of the banks is the same as that of the described bank guarantees of European banks.

III. The Contractual Relationship Between Customers and Banks Giving such Guarantees

On the basis of the contractual relationship between the customer and the bank which has been asked for a guarantee the bank is obliged to provide an appropriate guarantee or surety. The customer must for his part do everything to avoid default on the primary obligation and with it claims under the guarantee. If it comes to a claim under the guarantee, the customer must repay to the bank as compensation for expenses the amounts which the bank had to pay to the beneficiary on the basis of the guarantee. Thus the bank can to this degree take recourse against its customer.

This recourse can be based, according to the established view in the English, German and romanic legal systems, on two legal theories; there are two kinds of remedies.

First, the legal concept of subrogation helps the surety which had to pay the claim on the principal debtor. The claim of the creditor against the principal debtor devolves by operation of law upon the paying surety and thus in our case upon the bank. That then has meaning especially when preferential rights are bound up with the claim. For example, if tax postponement is secured through a bank surety, the bank which must pay surety can assert the priority rights belonging to the finance office in the case of the insolvency of the primary debtor. The same applies for the payment out of security which the customer of the bank had given to the creditor in his merchandise or in his outstanding debts.

In any case, however, the paying bank can base its recourse on the contractual relationship with the customer. On the basis of this relationship it has a claim for compensation for expenses which result from the establishment of the surety or the guarantees. That is then especially important where the bank paid or was obliged to pay as surety although the claim under the guarantee was doubtful or ineffective. We will come back to this case again shortly. Circumstances permitting, however, the contractual claim can also be directed against a person other than the primary debtor. Consider for example the following case: the foreign subsidiary of a domestic company must give a bank suretyship for exports and the bank receives from the parent corporation the order to undertake this suretyship or guarantee. If in such a case there is a claim under the suretyship or guarantee, the bank can, from the standpoint of subrogation proceed against the subsidiary as debtors, and from the standpoint of contractual compensation for expenses, the bank can proceed against the parent corporation which had given the order for the guarantee.

Let us now consider another aspect of the contractual relationship between the customer and the bank giving a guarantee for him. If it is doubtful whether a default has occurred and thus whether the claim of the beneficiary for repayment or compensation for damages is established, the bank can find itself in a very uncomfortable position. It is manifestly not in a position to judge the substantiality of the claim. It must assume that its client, who is contesting the claim of default, is biased in its reports to the bank. With a view to its standing and to the reputation which its guarantees must enjoy, the bank cannot postpone payment under the guarantee or without foundation contest its duty to pay. Therefore the banks as a rule have their customers make it possible for them to make payment on the first demand, that is, where there is simple assertion by the beneficiary of default. Thus it says in the standard trade terms of German private banks: "If the bank assumes suretyship or other guarantee duty at the order of or for the account of the customer, it is without judicial proceeding justified in making payment on the simple demand of the creditor". Correspondingly, it is said in the standard trade terms of the German Federal Bank: "If the bank is subject to claim on the basis of a foreign suretyship or guarantee, it is without judicial proceeding justified in paying on the demand of the creditor". If in such a case the default asserted by the creditor does not actually exist, recourse along the lines of subrogation is not possible. The bank can, however, depend for its recourse on the contractual relationship with its customer.

IV. The Rights of the Guarantee Beneficiary

To be distinguished from these problems is the question of when the beneficiary of a suretyship or guarantee can make a claim against the bank for payment. As we have seen the bank normally has the right to pay on first demand. That does not mean that the beneficiary can claim such payment on first demand.

Normally the suretyship is conditional. The surety is liable only to the extent that the primary debtor is liable. Objections which the primary debtor could assert the surety can also assert. The liability of the bank as surety cannot go further than that of the primary debtor to its customer.

But this general rule of the anglo-american, romanic and German legal systems is not mandatory. The parties can agree on something else and in the area of bank suretyship they often do that. In order to increase the value of the suretyship, it is written into the text of the suretyship agreement that the bank will effect payment on the first demand without complaint if the beneficiary asserts default by the primary debtor. One finds something like the following clause: "payment on first demand, and notwithstanding any contestation by the supplier or by ourselves or by any other party".

Bank guarantees formulated in this way are as good as a cash deposit. Historically, they take the place of earlier frequently demanded

cash deposits. Especially governmental bodies as orderers in many countries formerly demanded cash deposits as security. Then in their place came bank acceptances, and today these are replaced by bank guarantees through which the payment is provided on first demand.

In these cases the bank is not only authorized to make payment as against the customer but the bank is also obliged as against the beneficiary to render payment on first demand.

Should the exercise of the rights of the guarantee by the beneficiary be without foundation, the customer is forced to demand his money back from the contracting partner and to go to court for this purpose in the country of the beneficiary.

In case of default, suretyships of this kind spare the guarantee beneficiary from having to enforce in court in the country of the contract partner his demands for damages or his demands for repayment of the already tendered payment. The roles of the parties are reversed and the other contract must sue for repayment of amounts paid on the basis of the guarantee if he considers the exercise of the right of the guarantee to be unfounded.

Let me give an example. The shipping company which pays in instalments for the building of a tanker, provides the shipyard which has taken over the building of the tanker with effective credit. It is relieved, however, of the insolvency risk as well as of the risk of inability to enforce in a foreign trial, if it has received a first-demand re-payment guarantee from a bank in his own country for the possible repayment of tendered instalments.

This reversal of the roles is the most important function of guarantees which are payable on first demand. Whoever receives such a guarantee need not enforce his demand by suing in a foreign country. He receives his money immediately through the bank guarantee, which is generally established with a bank in his own country. The primary debtor depends on the right to demand his money back through a suit if he thinks that there was no default.

V. Improper or Wrongful Exercise of the Claim under the Guarantee

Bank guarantees in which payment is promised on the first demand are thus for beneficiaries in international transactions as good as cash, especially if they are established with a bank in their own country. That means complete security for the contract partner for whose benefit the bank guarantee is given but it can also lead to abuses.

A. Objections in Cases of the mala fide Exercise of the Rights of the Suretyship

If the exercise of the rights of the suretyship is obviously fraudulent, the bank naturally need not pay. The same principles apply as in

the case of confirmed letters of credit. In the case of deceitful or fraudulent implementation, the bank need not pay. It bears the burden, however, of having to prove the existence of such a case of fraud. The bank, for the sake of the reputation of its own guarantees, will only use charges of fraud in really obvious cases.

Occasionally banks have attempted to help their own customers by causing the customer's claims against a contracting partner to be assigned to the bank and then asserting them as a form of set-off against the guarantee obligation to the contract partner. The courts have, however, as in the law of letters of credit, declared that to be unacceptable, for it would be contrary to the sense and purpose of bank guarantees, which is to guarantee to the debtor a payment on the first demand.

Another approach of customers who find the implementation of the guarantee which they had established to be unjustified is the following. They have tried to secure an injunction from their own courts by which the bank is forbidden to pay on the basis of the guarantee. This approach, which is repeatedly given "one more try", does not work. The legal relationship between the bank and the guarantee beneficiary may not be interfered with by an injunction obtained by the customer. The customer is thus left to work out the problem with his contract partner. Here of course he can try to hinder the beneficiary through an injunction obtained against his contract partner's attempt to make a claim under the suretyship. But this injunction must be obtained outside the country. And generally it comes too late to prevent the claim under the guarantee.

B. Efforts of the International Chamber of Commerce to achieve a Regulation of Bank Guarantees

The International Chamber of Commerce in Paris has been trying for a long time to work out principles for the use of bank guarantees and claims thereunder, which would represent a parallel to the *Uniform Customs and Practice for Documentary Credits* which have been in effect since 1962. So far these efforts have been unsuccessful. The same applies for UNCITRAL, the United Nations Commission on International Trade Law. It has also taken up the problems of bank guarantees, but has not achieved concrete results. Of interest, however, are the main problems which have been discussed in the preparation of the proposed principles of the International Chamber of Commerce. They involve, above all, the increasing number of cases of unjustified claims under guarantees payable on first demand.

It is reported that tender guarantees are being misused by those calling tenders, especially in state trading countries. The tender guarantee should, as we have seen, serve to ensure that a bidding firm will, after receiving a contract, also sign and perform it. The offers established at

a fixed price are at present regularly valid for six months or a similar period. If the bid letting country cannot decide within this period on the conclusion of the contract, the threat of a claim under the tender guarantee is not infrequently used to coerce the competing firms to extend the effective dates of their offers, in spite of the fact that prices have in the meantime increased. A claim under a tender guarantee where a contract is not awarded is indeed obviously improper. The bank, however, for the sake of its good name, regularly pays on the first demand. This applies, particularly when a state trading country and a bank in that country are involved. The bank cannot in any way risk refusal to pay on the guarantee. The demanding back of once paid sums in a state trading country encounters, however, great difficulties. Also performance guarantees payable on first demand have been misused in increasing numbers. The orderer files a claim under them and sees in it a kind of rebate which is due him.

The International Chamber of Commerce wanted therefore to introduce a regulation that when a client opposes payment on the guarantee, the bank can make payment only if it is supported by a judicial or arbitral decision. Thus for a period the fulfilment of the guarantee would be postponed. The european export industry emphatically advocated a solution of this type. Whether the guarantee beneficiaries will have anything to do with it is, however, another question. If adequate quick-working arbitration panels which have the trust of both parties can be made available, that may be possible. The bank guarantee retains in any case the advantage of relieving the beneficiary contract partner of the risk of insolvency. The banks are however, against such a formulation of bank guarantees because they think that in this way the bank guarantees lose too much of their worth. For my part I am inclined to believe that those that are in a position to demand bank guarantees will not generally agree to a situation where they have to go first to an arbitration panel before they can make a claim under such a guarantee.

C. Security through Counterguarantees

More promising perhaps is the approach which seems to have met with some success in the scandinavian countries. The scandinavian producer or contractor is indeed prepared, as before, to cause its bank to issue tender, performance or re-payment guarantees on first demand. It requires, however, from the beneficiary a counterguarantee for re-payment of the guarantee sum in case it is proven through an arbitration decision that a claim under a guarantee for tender, re-payment or performance payable on first demand was unjustified. In this way the guarantee payable on first demand retains its value of securing to the beneficiary immediate satisfaction. The beneficiary must, however, avoid improper claims under the guarantee, since in such a case a claim can be made on him on the basis of an arbitration decision under the counterguarantee which he has established.

Also this technique shows how flexibly the system of bank guarantees can be applied in the enforcement of rights across national boundaries, and how it overcomes difficulties which the attainment and execution of judgments by courts in different countries appear unlikely to be able to overcome easily.

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