LECTURE NO.8

THE ROLE OF GUARANTEES AND BONDS IN INTERNATIONAL TRADE

A guarantor issues a guarantee or bond, usually a bank or an insurance company, on behalf of an *exporter*. It is a guarantee to the buyer that the exporter will fulfil his contractual obligations. If these obligations are not fulfilled, the guarantor undertakes to pay a sum of money to the buyer in compensation. This sum of money can be anything from 1% to 100% of the contract value.

If a bank issues the bond, then the exporter is asked to sign a counter indemnity, which authorises the bank to debit his account with any money, paid out under the bond.

Bonds are usually required in connection with overseas contracts, or with the supply of capital goods and services.

Middle Eastern countries commonly require bonds, but nowadays, many other countries also require them. Most international aid agencies, such as the World Bank or the European Development Fund, and most government purchasing organisations in the developing world, plus major purchasers of goods and services in the North Sea Oil sector now require bonds from sellers.

In the international trade, it is usually difficult for the buyer of goods and services to estimate the professional and financial abilities of the supplier. So, the buyer is interested to request a guarantee, which proves that the seller is able to follow his commitments.

On the other hand, the bank guarantee is mainly limited to covering the right of unpayment, provided that the payment system based on invoices is used.

Bonds: definition, parties involved, elements, and types

The bank guarantee represents an irrevocable engagement assumed by a bank to pay a cash amount in the case that a third party does not respect his duties to deliver certain goods, perform certain services or follow payment. The guarantee represents itself an engagement, independent of the contract signed between the creditor and the debtor.

From the moment when the bank guarantee is issued, the bank is responsible to pay at first request to the beneficiary of the bank guarantee, if the conditions stipulated if the guarantee is correct.

Usually, the guarantees are subject to the national law of the issuing bank.

There are two methods to issue a bank guarantee, as follows:

- *direct*, by using the bank from the seller's country to issue the guarantee in favour of the foreign buyer;
- *indirect*, the bank from the seller's country empowers a foreign bank to issue a guarantee in favour of the buyer.

The wording of a guarantee is very important. It needs to be *clear, precise, and simple.* Accordingly, all guarantees should include the following parties involved:

a) the Principal who is requiring the issue of the guarantee, bond.

b) the Beneficiary is the person in the favour of whom the payment shall be made.

c) the Guarantor is a bank. It issues the guarantee, bond.

Important inclusions as far as the UK bank is concerned are:

a) name and address of beneficiary;

b) clear and unambiguous wording;

c) definite expiry date;

d) maximum bank liability stated;

e) guarantee for monetary payment only, i.e. no goods involved;

f) time period for submission of claims under guarantee;

g) procedure for claims;

h) drawn subject to English law, where possible.

In Romania the guarantee or bond is called a letter of guarantee. Taking into consideration the important role of the bonds in the international trade, the International Chamber of Commerce from Paris and other international bodies wanted to standardise the practices in the bond field.

Thus, in 1978, the International Chamber of Commerce from Paris elaborated “the Uniform Rules for Contract Guarantees”, called “the Publication No. 325”, with the view to securing a uniformity of practice based upon an equitable balance between the parties concerned.

In 1992, the International Chamber of Commerce from Paris issued a new set of rules called “the Uniform Rules for Demand Guarantee” or “the Publication No. 458” (see Annex No. 2).

It should be mentioned that nowadays both the Publication No. 325 and the Publication No. 458 is into force.

In Romania, banks apply these two sets of rules in the guarantee field.

The main elements of a guarantee are:

a) the *parties involved* (the beneficiary, the principal);

b) the *guarantee purpose/object* (e.g. Under this contract the buyer is to pay them sum of…as *an advance payment being …%* of the contract value in favour of the seller);

c) the *guarantee value* (e.g. In consideration of the above conditions, we Bank …hereby give you our guarantee and undertake *to pay irrevocably the amount of….*);

d) the *assignment formulation of the bank* (e.g. The Bank……….undertake to pay the amount….*on receipt of your first demand in writing*);

e) the *terms of payment*;

f) the *guarantee validity* (e.g. This guarantee is valid for written…..*on or before …after which date our liability…..will cease*);

g) the *legislation clause* (e.g. This guarantee *shall be governed by English law*).

There are several types of guarantees, which the seller may be called upon to provide in favour of the buyer. The most common types of guarantee are:

a) Tender or bid bonds

This type of guarantee is necessary in the case of public offer requests. The purpose of a tender bond is to indicate to the buyer that the tender is a serious offer and the party submitting it will sign the contract if the tender is accepted. The buyer will be confident in the knowledge that the seller is financially able to enter into such an undertaking. The validity term is until the signing of the contract or the delivery of a performance bond (usually from three to six months). Finally, it is an assurance to the buyer that on award of the contract subsequent guarantee requirements to secure performance and/or advance payments will be forthcoming.

A tender or bid bond is usually for between 2% and 5% of the contract value, and will guarantee that the exporter will take up the contract if it is awarded. Failure to take up the contract results in a penalty for the amount of the bond. In addition, the tender bond usually commits the exporter and his bank to joining in a performance bond if the contract is awarded. Tender bonds serve to prevent the submission of frivolous tenders.

b) Performance bonds

These are the most commonly used types of guarantee. The purpose of a performance guarantee is exactly what it states – to ensure performance by the seller in accordance with their contractual obligations. Thus, the performance bond is given at the seller's request by the bank, which commits itself to pay to the beneficiary the guaranteed sum, in the case that the supplier does not fulfil his contractual obligations.

Performance bonds guarantee that the goods or services will be of the required standard and a stated penalty is payable if they are not. The amount payable will be a stated percentage of the contract price: often 10% but sometimes more.

The validity term is for the entire amount until the complete execution of the contract.

c) Advance payment bonds

Advance payment bonds undertake to refund any advance payments if the goods or services are unsatisfactory. The validity term is until the end of the complete delivery of the object of the contract.

d) Warranty or maintenance bonds

Warranty or maintenance bonds undertake that the exporter will maintain the equipment for a period of time. Maintenance guarantees are normally requested in connection with construction contracts. The purpose is to ensure that once construction has been completed the obligation of the contractor will be fulfilled during the maintenance period.

e) Retention bonds

Retention bonds enable retention money, which would otherwise be held by the buyer beyond the completion of the contract, to be released early. These bonds guarantee the returns to the buyer of the retention money in the event of non-performance of post-completion obligations by the exporter.

A retention money guarantee enables the seller to receive the total amount of each payment while assuring the buyer that these funds will be payable in the event of a failure of performance.

f) Recourse bonds

Recourse bonds are sometimes demanded by the ECGD to cover the potential recourse by the ECGD under buyer credit.

g) Stand-by letter of credit

This type of credit, which has the characteristics of a guarantee, is especially used in the United States of America, where the law does not entitle the banks to issue guarantee, in the European meaning of the word.

An alternative to the bond is a stand-by letter of credit issued by the UK bank in favour of the importer, promising to pay a given amount against specified documents, usually a formal default claim. From the UK bank's point of view, a stand-by letter of credit is better than a bond because it will be subject to UCP for documentary credits instead of being subject to complex legalities. In addition, a stand-by letter of credit will always have a definite expiry date.

All these types of guarantees may take the form either of *bank demand guarantee* or of *surety default bonds*.

a) *Demand guarantee/bond* or *Bank first demand guarantee* – where the bank undertakes to pay away funds on claim.

b) *Surety bonds* – where the surety is bound to make good any defaults of the constructor, e.g. remedial work. Insurance companies, not banks, normally issue these bonds.

Since a bank will not wish to have primary responsibility for the fulfilment of a customer's contractual obligations, the bank will issue only demand guarantees.
Demand guarantee can be:

- *Simple* – when the beneficiary claims, bank pays, i.e. no conditions, or
- *Conditional* – where the beneficiary must support the claim with specific documentation. Conditional bonds can be divided into two types:

- *Conditional bonds* requiring documentary evidence; they give maximum protection to the exporter, and
- Conditional bonds which do not require documentary evidence.

Any claim received where the guarantee is payable on *simple demand* must be honoured, whether or not the seller claims that they are not in default.

On demand bonds

These bonds, sometimes known as *unconditional bonds*, can be called at the sole discretion of the buyer. The bank must pay if called upon to do so, even in circumstances where it may be clear to the exporter that the claim is wholly unjustified. UK courts have often ruled that the bank must honour claims under demand bonds.

If the bank has to pay under the bond, it will debit the customer's account under the authority of the counter indemnity. The exporter will then be left with the unenviable task of claiming reimbursement in the courts of the buyer's country.

It should be mentioned that banks never become involved in contractual disputes. If payment is called for which conforms to the terms of the bond, the bank must pay.

Under the provisions of the Uniform Rules concerning the bank demand guarantee, any *demand bond, guarantee* or *other instrument* in writing issued or executed by the *Guarantor* in favour of the *Beneficiary* pursuant to which the Guarantor undertakes on Default[1], either:

i. to pay or satisfy any claim or entitlement to payment of damages, compensation or other financial relief up to the *Bond Amount*[2]; or
ii. to pay or satisfy such claim or entitlement up to the Bond Amount or at the *Guarantor*[3]'s option to perform or execute the *Contract*[4] or any *Contractual Obligation*[5].

Bank demand guarantee imposes legally binding obligations on a bank. It may provide for payment to the buyer either on first or simple demand, or on first or simple demand supported by a document or documents referred to in the guarantee. That means that if a Bank receives a demand, which on

[1] Articles 2 from ICC Uniform Rules for Contract Bonds – "Any breach, default or failure to perform any contractual obligation which shall give rise to a claim for performance, damages, by the Beneficiary."
[2] Idem - "The sum inserted in the bond as the maximum aggregate liability of the Guarantor…"
[3] Idem – "Any Person who shall issue or execute a Bond on behalf of a Principal."
[4] Idem – "Any written agreement between the Principal and the Beneficiary for the carrying out of works the performance of services…"
[5] Idem – "Any duty, obligation or requirement imposed by a clause, paragraph, term, condition…of the Contract."

its face complies with the terms of the guarantee, the Bank is obliged to pay without any reference to the seller.

Accordingly the Uniforms Rules on demand bonds, all guarantees should stipulate:

a) the Principal;

b) the Beneficiary;

c) the Guarantor;

d) the underlying transaction requiring the issue of the guarantee;

e) the maximum amount payable and the currency in which it is payable;

f) the Expiry Date and/or Expiry Event of the guarantee;

g) the terms for demanding payment;

h) any provision for reduction of the guarantee amount.

A guarantee enters into effect as from the date of its issue unless its terms expressly provide that such entry into effect is to be at a later date or is to be subject to conditions specified in the guarantee and determinable by the guarantor on the basis of any documents.

The UK banks basic requirements are that any guarantee, which it is asked; to issue should comply with the following criteria:

1. The guarantee must be for a defined sum of money either in sterling/Euro or in a specified foreign currency. The guarantee must not place upon the UK bank any obligation other than payment of a defined sum of money.
2. The wording of the guarantee must be clear and unambiguous. In particular, the circumstances in which the UK bank is to pay a claim must be clear, e.g. simple demand or a demand supported by signed statements and/or specified documents. The UK bank will not enter into a commitment, which involves acting as an arbitrator between its customer and the buyer.
3. The guarantee must provide for termination on a specified date or on an indisputable event, e.g. the issue and production to the UK bank of a specified architect or engineer's certificate.
4. The guarantee must be non-assignable by the beneficiary.

An overview of the Uniform Rules for Demand Guarantees

The first function of the Uniform Rules for Demand Guarantees (see Annex No.2) is to codify rules of good practice to which parties subscribe by incorporating the rules in their contracts. Thus, the Rules provide a contractual framework for the relationships between the guarantor and the beneficiary, between the Instructing party and the guarantor, and between the principal and the guarantor or the instructing parties.

The text of the Rules is prefaced by an Introduction, which describes the purpose and scope of them, the legitimate expectations of the various parties and the concern of the International Chamber of Commerce to encourage good demand guarantee practice. The text itself consists of 28 article divided into six sections, as follows:

A. Scope and Application of the Rules

B. Definitions and General Provisions

C. Liabilities and Responsibilities

D. Demands

E. Expiry Provisions

F. Governing Law and Jurisdiction

It should be mentioned the three fundamental principles of demand guarantee law, as follows:

- the independence of the guarantee from the underlying transaction;
- the documentary character of the guarantee;
- the guarantor is concerned only with whether demands and other documents appear on their face to conform to the guarantee.

One of the main important parts of the Rules is the Section C that is devoted to the liabilities and responsibilities of the parties. These are broadly of three kinds: to examine, to inform and to transmit.

Section D of the Rules is devoted to the important subject of demand and contains a rule designed to provide some safeguard against unfair calling whilst preserving the documentary character and speed of implementation of demand guarantees.

A demand guarantee must be made on or before the expiry date of the guarantee and before any expiry event. It must comply with the express terms of the guarantee and to independent documentary requirements.

The main problems which bonds cause for exporters are:

a) The effect of bonds on the credit rating of the exporter.

Banks treat the issue of bonds in exactly the same way as they would treat any lending facility. If payment is called for within the terms of the bond, the bank must pay, irrespective of whether its customer has funds to honour the counter indemnity. Hence banks would normally wish to reduce a customer’s maximum borrowing facilities pound for pound by the same amount as the bond.

Tender bonds involve the worst problems. The average success rate is often said to be one in eight for tenders, so the average contractor may at any one time have eight tenders outstanding. If each of these tenders involves a tender bond, say 2%, and then the exporter’s total potential borrowing facilities are reduced by 16% of his overall tender volume.

b) Unauthorised extension of bonds.

Some countries, such as Syria, have laws, which prevent the local bank from cancelling the bond without the importer’s specific authority. This prohibition applies even if the bond contains an expiry date.

Sometimes the local bank will threaten to call for payment unless the bond is formally extended. The usual result is that the local bank is able to persuade the UK bank to extend the bond, and that the annual bank charges continue to be levied by both banks.

Sometimes tender bonds are not cancelled, even when the contract has been awarded and a performance bond has been issued.

c) Unfair calling of bonds.

The buyer may call for payment, even when such a call is unjustified. If the call conforms to the terms of the bond, the bank must pay and will debit the exporter’s account under the terms of its counter indemnity. The exporter can be left with the task of claiming reimbursement from the buyer via the overseas courts.