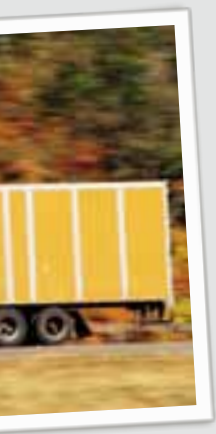


Bank Guarantees in International Trade



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Preface

The purpose of this publication is to convey an understanding of bank guarantees in international trade, as well as to outline the rules and practices applicable in this area.

We hope you will find this publication useful whether you intend to use or are already using bank guarantees. Please feel free to contact us should you require any further information. We are always prepared to advise or assist you in matters related to your bank guarantee business.

For further information or material, please contact one of our trade finance departments. You will find the contact details on the back of this publication.

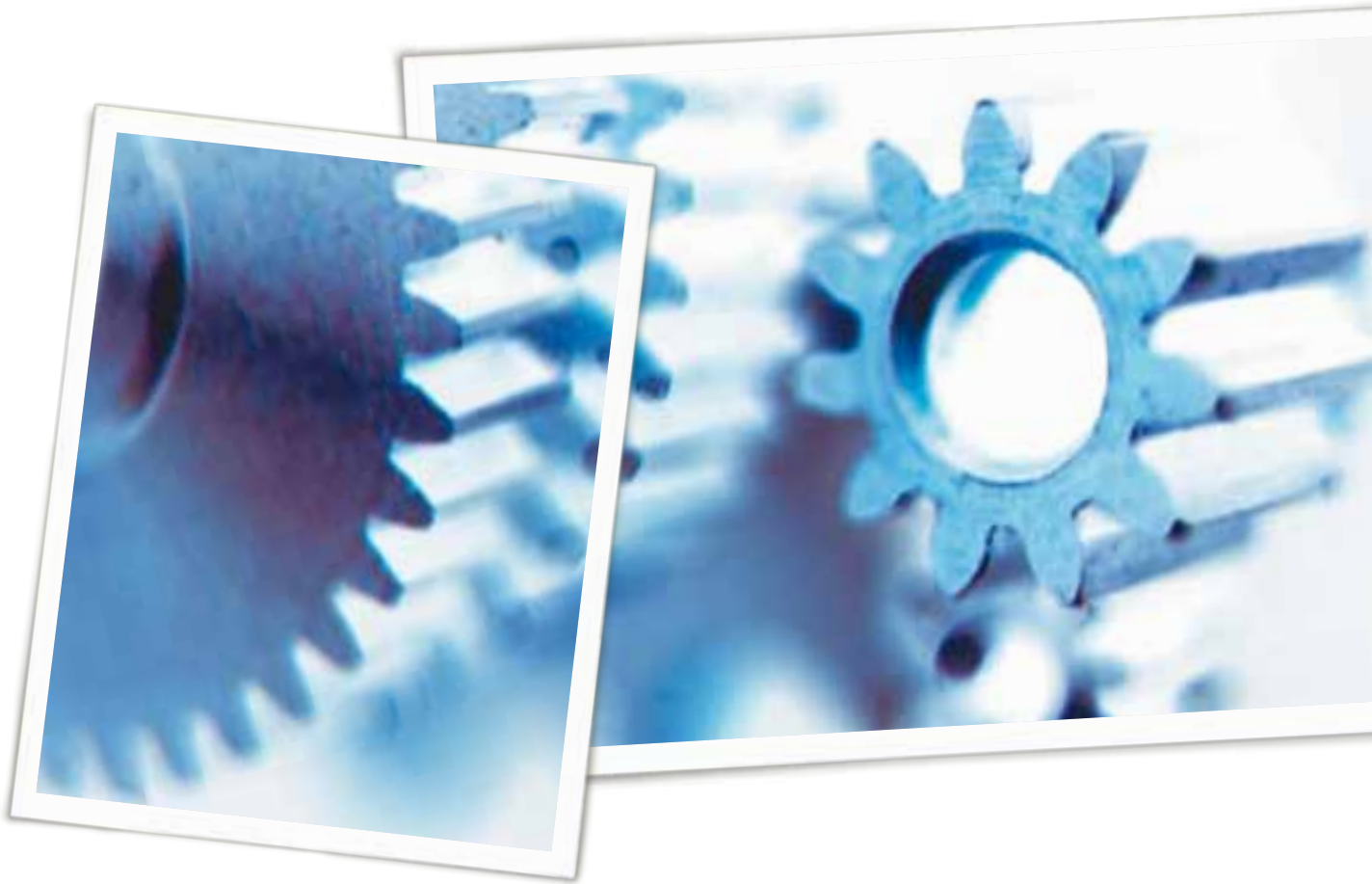
Nordea Trade Finance, 2010



Other related publications issued by Nordea:

Documentary Credits (2009)

Reinhard Längerich: *Documentary credits in practice* (Second edition – 2009)



Acknowledgement

We would like to give special thanks to Glenn Ransier (US) for his comments on this publication.

Mr. Ransier is an international expert on documentary credits and guarantees. He has been involved with trade finance for almost 30 years. He served as a member of the URDG Drafting Group, the group of experts appointed by the International Chamber of Commerce to draft the revision of URDG 458, now entitled URDG 758.

Mr. Ransier is author of the book *A Drafter's Notes to URDG 758*.

Introduction

Bank guarantees play a vital role in international trade and other business transactions. They are used in almost every phase of the transaction between the buyer and the seller. This publication explains the terminology, rules and practices for bank guarantees in international trade. The information provided is based on our acquired expertise in this field, as well as the ICC *Uniform Rules for Demand Guarantees*, ICC Publication No. 758 (URDG 758).

This publication will consider the bank guarantee from two perspectives. The first section provides general information on guarantees, the specific purpose for which they are used in the transaction (Chapters 1– 4). The second section (Chapter 5) provides an introduction to URDG 758 by focusing on the parties to a guarantee as defined in these rules, as well as taking the practitioner step-by-step through the process of a single demand guarantee issued subject to them. The guarantee transaction used to exemplify the use of guarantees is a standard demand guarantee issued by a guarantor on behalf of an applicant/instructing party. Where appropriate, other guarantee structures will be described as well.

Article numbers referred to in this publication are the articles contained in URDG 758.

Bank guarantees can have different names, even when used for the same purpose: for example, a tender guarantee may also be referred to as a bid bond. For the purpose of this publication the word “guarantee” will be used.

This publication aims to provide an easy-to-read introduction to the guarantee. To assist the reader, an appendix describing the commonly used technical terms has been included (Appendix 1). The terms defined in the appendix are also underlined in the text.

The terminology used in this publication is the same as that used in URDG 758, regardless if it is used to describe a guarantee subject to these rules or to make a general statement about guarantees.

In general, this brochure deals with demand guarantees as opposed to accessory guarantees. For information about accessory guarantees refer to Chapter 2, Accessory guarantees.

Nordea’s standard guarantee texts, as well as an application for issuing a guarantee, are available on www.nordea.com/tradefinance.

We hope this publication will be helpful to all practitioners in the field.

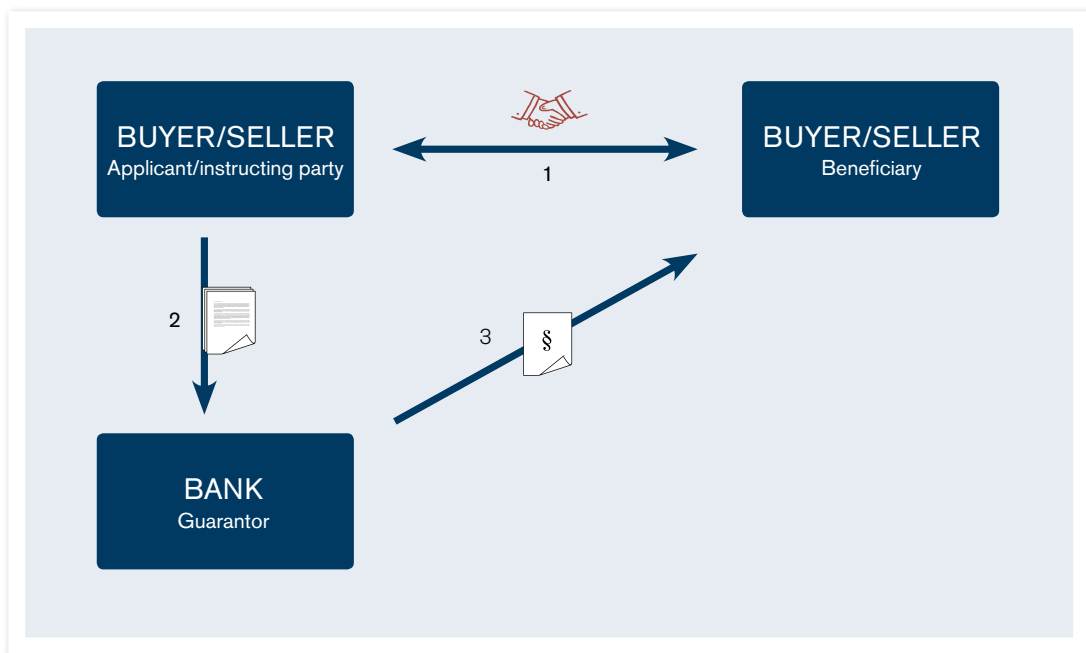
Introducing the bank guarantee

Some situations require that a third party (often a bank) guarantees to pay a sum of money to one party if the counterparty defaults, for example if the counterparty fails to deliver a project within the agreed time lines. As such, the guarantee transfers the creditworthiness of the applicant/instructing party of the guarantee to the bank (the guarantor).

It is important to understand that what the guarantor guarantees is to pay an amount of money to the beneficiary, not to complete the project, fix the machine, deliver the goods or whatever else may be the subject of the guarantee. In fact, the guarantor does not guarantee that the applicant/instructing party will fulfil its obligation; it only commits itself to pay, in whole or in part, the amount stated in the guarantee.

As noted, this publication will primarily discuss demand guarantees (sometimes called first demand or document guarantees), which are those payable by the guarantor upon presentation to it of a complying demand/documents submitted by or on behalf of the beneficiary. For these types of guarantees, the guarantor will review the presented documents solely against the terms of its guarantee to determine if a payment is warranted. The guarantor will *not* review the underlying goods or services or the applicant/beneficiary contract/relationship.

Figure 1



- 1) Agreement between buyer and seller
- 2) Guarantee application/counter indemnity (from applicant to the guarantor)
- 3) Issuance of the guarantee by the guarantor

In many ways a guarantee is a very simple instrument: a bank (the guarantor) guarantees to pay a certain amount of money provided pre-described documentation is presented to the guarantor. However, other elements need to be considered. First, although the guarantee is independent from the underlying transaction between the parties, it is there to support that transaction. Consequently, it is important that the text of the guarantee clearly expresses exactly what the guarantee is to cover. Second, unlike with documentary credits, lawyers are often involved in drafting the text for an individual guarantee. This is because the guarantee instrument is very flexible, meaning it can be used for all kinds of purposes. Although the use of standard texts is preferred, because of this flexibility, an individual text, in many instances, may require legal assistance in its preparation.

To understand what a guarantee is one must be familiar with a few important concepts, as described below.

Definition and purpose of a bank guarantee

A guarantee may be defined as:

An independent, documentary undertaking by which a bank (or other legally qualified entity) (the guarantor), issues, at the request of its customer (the instructing party), its irrevocable guarantee to pay a sum of money to a third party, (the beneficiary), provided a complying demand/document(s) is presented.

This definition contains some of the core principles concerning these kinds of guarantees.

A guarantee is an *independent undertaking* by a bank (hereafter called “guarantor”). This undertaking means that the guarantor becomes obligated to pay an amount, specified in the guarantee, provided the terms of its guarantee are complied with.

A guarantee is *irrevocable*, meaning that once issued it cannot be amended nor cancelled during the validity period without the consent of the parties, i.e. the guarantor and the beneficiary.

The guarantee is usually a “passive instrument” in the sense that, once issued, it is not expected to be drawn on, because the applicant/instructing party and beneficiary will generally settle the underlying contract/relationship outside of the guarantee. The guarantee remains until its expiry and serves as security under the commercial transaction. In most cases, demands are only made when the applicant/instructing party is in breach of its underlying contract/relationship.

When used, the guarantee becomes a “payment instrument”. The trigger for payment is the presentation of a demand and other required documents to the guarantor as stipulated in the guarantee.

However, there are occasions in which the demand guarantee is meant to be the main payment instrument. Typically, these types of guarantees will require a long list of commercial documents in addition to the simple demand issued by the beneficiary.

Types and forms of guarantees

This publication uses the term bank guarantee (or guarantee) in a general way to cover the various kinds of guarantees, which come in various forms, types and structures. The following is a walk through the most common types.

Independent and accessory bank guarantees

One way of grouping guarantees is to classify them as either independent or accessory. When a guarantee is issued, it is essential that the guarantor and the applicant/instructing party know which type of guarantee they are dealing with. The guarantee text should not include elements from both types.

Independent bank guarantees

At the outset it should be noted that guarantees are independent from the underlying relationship and the guarantee application. 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 guarantor deals with documents and not with goods, services or performance to which the documents may relate.

In addition, a guarantor is not liable for the effectiveness of the documents, i.e. a guarantor will not go beyond the documents to check if the information contained therein is correct.

This form of guarantee is often referred to as “demand guarantee” or “first demand guarantee”. These terms effectively describe the nature of the guarantee. When a demand is made to the guarantor, and is in compliance with the terms of the guarantee, the guarantor is obligated to pay regardless of the underlying relationship. The obligation is based solely on the guarantee and the demand.

Several other words are often used in connection with demand guarantees; namely, “unconditional”, “abstract”, “autonomous” and “primary obligation”.

The information in this section applies to the majority of independent guarantees.

Accessory bank guarantees

An accessory guarantee is one in which a guarantor binds itself for a fixed amount in order to cover a debt or default, etc., for its applicant/instructing party, who is already bound to the beneficiary via the underlying contract/relationship. Should the applicant/instructing party become unable to fulfil the underlying contract, the guarantor becomes obligated to pay according to the terms of the guarantee.

In an accessory guarantee there is a linkage between the guarantee and the underlying contract. In most cases, this means that a **demand** must prove the contractual default and the guarantee will often require an award consisting of the amount resulting from the default.

Accessory guarantees are dependent on local legislation. In many countries, the duration of the guarantee could be jeopardized if local legislation provides protection against guarantees that expire before the underlying contractual obligations are fulfilled.

The accessory guarantee obligates the guarantor to the beneficiary of the underlying contract/relationship as if they were the applicant/instructing party.

It is important to note that the guarantor's obligations can never exceed the obligations of the applicant/instructing party as the contracting party.

The term “accessory” is usually translated as “as for our own debt”. The English term often used is “suretyship” or “conditional guarantee”. As in the case of demand guarantees, it is the wording of the guarantee and not its title that will determine the type of undertaking it is.

As noted, these accessory guarantees are often subject to local law or silent with regard to what governs them. Since guarantee laws differ significantly from country to country, caution should be exercised when using these instruments. An accessory guarantee cannot be issued subject to URDG 758 (The ICC *Uniform Rules for Demand Guarantees*) nor to other sets of ICC rules; UCP 600 and ISP98.

Commercial and financial bank guarantees

Another way of grouping guarantees is to classify them according to whether they cover a commercial or a financial transaction. This becomes relevant for the applicant/instructing party in determining the guarantee commission to be paid to the guarantor. In general, financial guarantees are considered riskier than commercial guarantees, since commercial guarantees are linked to day-to-day business. Therefore, the commission to be paid for a financial guarantee will often be higher than that for a commercial guarantee.

Commercial bank guarantees

A commercial guarantee is one that covers a commercial transaction – for example the delivery of goods, the completion of a project or the building of a factory. In general, the subject of the guarantee is something tangible like goods or buildings, though it could also include services.

Again, it is important to note that the obligation of a guarantor does not depend on the actual fulfilment of the applicant/instructing party's obligation. The guarantor only commits itself to pay, in whole or in part, the amount stated in the guarantee.

Financial bank guarantees

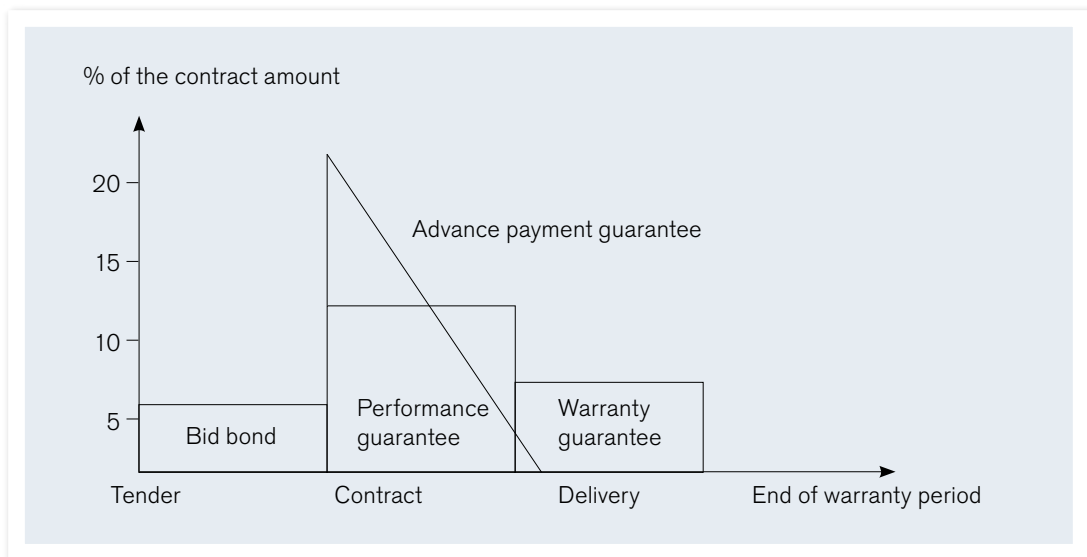
A financial guarantee is one that covers a financial transaction – for example to serve as collateral for a loan obtained.

Different types of bank guarantees - specified by purpose

Because guarantees are flexible and can be structured to cover a variety of needs, it can also be useful to group them according to their purpose.

Below are descriptions of some of the most common types of guarantees grouped in this way. In this publication we have chosen to divide them into three categories: export, import and other guarantees.

Figure 2



Export guarantees

An export guarantee is a guarantee in which the seller/exporter serves as applicant/instructing party of the guarantee.

Bid/tender guarantee

When a company invites tenders, it is not uncommon that it will require that the tenders be accompanied by a tender guarantee.

The tender guarantee covers the risk that the company submitting the tender will not abide by its offer, will not sign the contract if awarded to it or will not submit the required performance guarantee.

A tender guarantee is normally issued for 2% or 5% of the value of the tender (contract value).

Often the tender documents indicate that the tender guarantee is to be replaced by, for example, a performance guarantee when the contract is signed (see Figure 1).

If the company is not awarded the tender, the guarantee should be released immediately by the beneficiary.

Advance payment, down payment or repayment guarantee

Although entitled differently, the guarantees in this section represent the same type of guarantee.

Their purpose is to ensure the repayment of an advance which the applicant/instructing party of the guarantee has received or will receive for a delivery or for work to be done.

In connection with large contracts, especially international transactions, the parties sometimes agree that the supplier or contractor is to receive a certain percentage, for instance 10% or 30% of the contract amount when the contract is signed. This provides the supplier or contractor with the financial basis for getting the project under way, by offering it the possibility to buy raw materials or to pay wages during the initial phase. To safeguard the beneficiary against losing the advance payment, the recipient of the amount may provide a guarantee to secure the repayment of the sum should the goods not be delivered or the work not be done.

Usually the guarantee is to be provided before the amount is transferred. In this situation, the guarantee should stipulate that claims under the guarantee cannot be made until the guaranteed amount has been credited to an account specified by the supplier/contractor.

The contract between the parties will stipulate how the remaining sum is to be paid – whether as a lump sum on delivery or in instalments when the goods have been delivered or the work has been carried out. This part of the contract is not covered by the advance payment guarantee.

Performance guarantee

A performance guarantee is used to secure the applicant/instructing party's fulfilment of its contractual obligations toward the beneficiary. The guarantor undertakes to pay compensation up to a certain amount to the beneficiary in case the applicant/instructing party fails to deliver the goods or to carry out certain work.

Often the performance guarantee is for 10–15% of the value of the contract, but the percentage may vary from contract to contract.

Warranty guarantee

The purpose of this type of guarantee is to cover the applicant/instructing party's obligations after it has delivered the goods or completed its work during the contractual warranty/guarantee period.

Retention money guarantee

A retention money guarantee is used to secure the correct repayment of an amount paid in advance by the beneficiary if the applicant/instructing party fail to meet its contractual obligations during the warranty/guarantee period. This can be the case, for example, in projects when full payment is made against shipping documents but the completion of the contract has not yet occurred. The guarantee secures that the final completion of the contract will be properly fulfilled. Usually, this type of guarantee contains a clause stating that it is a condition for the payment of any claim under the guarantee that the retention money (the advanced amount) has been received by the applicant/instructing party.

For example, a contract (may) stipulate that payment of the last instalment (usually 10% of the contract amount) may be postponed until all contractual obligations of the applicant/instructing party have been fulfilled, usually against a Final Acceptance Certificate (FAC). The retention money guarantee secures the proper finalizing of the applicant/instructing party's contractual obligations.

The postponement of the last instalment (may) affect the applicant/instructing party's cash flow, and the actual date of payment, as well as the actual payment of the money, may be uncertain.

Since this guarantee replaces the retention part of the amount of the contract, it is often called a retention money guarantee.

Import guarantees

In this context, an import guarantee is a guarantee in which the buyer/importer serves as applicant/instructing party to the guarantee.

Payment guarantee

The purpose of a payment guarantee is to cover the applicant/instructing party's ability to meet its payment obligations.

The most common type of payment guarantee is one covering the buyer's obligation to pay for goods received or services rendered.

When the beneficiary has performed the contract (delivered the goods or completed the work) and the buyer does not meet its payment obligation, due to a lack of ability or a willingness to pay, the beneficiary may demand payment under the guarantee.

Normally, a payment guarantee is given for the full amount of the contract or, where part of the amount has been paid in advance, for the remaining amount.

The payment guarantee may be used to cover a specific consignment or contract, or it may cover the applicant/instructing party's outstanding balance arising from its regular business with the beneficiary.

When the guarantee is to cover this balance in connection with, for instance, the regular delivery of goods, the beneficiary must ensure that the guarantee amount is sufficient to cover the outstanding balance (assets) at any time. This means that, when calculating the guarantee amount, the seller must take into account the value of the individual deliveries (also the future ones), the frequency of deliveries and the credit period granted.

Guarantee for a missing bill of lading

This specific type of guarantee is used to authorize a transport carrier or its agents to release specified cargo to a consignee named in the bill of lading without the surrender of the original bill of lading.

The consignee is the applicant/instructing party of the guarantee, and the purpose of the guarantee is to secure the carrier if the bill of lading is later surrendered with a claim for the goods. This guarantee is also called an “indemnity”, as it is used to indemnify a carrier against losses and legal challenges in connection with the release of the cargo without the original bill of lading.

Customs guarantee

This type of guarantee is issued in favour of customs offices as security for payment of customs duties by an importer.

Other types of guarantees

Because of their flexible nature, guarantees may be used for many other purposes, some of which are listed below.

Guarantee for the repayment of a loan

This variant of a payment guarantee is a guarantee for the repayment due of a loan which a bank (or a company) has granted to the applicant/instructing party.

At first it may seem impractical and quite expensive to arrange financing by applying for a loan from one bank and a guarantee from another; however, in some cases this is common practice. Such a situation can occur, for instance, when a company’s foreign branch or subsidiary wishes to obtain a loan from a local bank. It may be less expensive and more practical to seek a loan locally rather than to borrow the amount from the head office.

Guarantee for a credit facility

In addition to banks providing guarantees for loans granted by other banks, banks can often be requested to issue a guarantee in favour of another bank which has granted its customer another type of credit facility. These facilities may include credit lines for documentary credits, guarantees and for overdrafts.

Guarantee for the payment of a bill of exchange (aval)

Bills of exchange are commonly used as a means of payment in international trade. The exporter, (the drawer) draws the bill of exchange and the buyer (the drawee) accepts it. In the bill of exchange, the terms of payment for the exported goods (amount to be paid, currency,

due date, place of payment, etc.) are determined. Often, and especially if the exporter and the buyer do not know each other very well, the exporter accepts the bill of exchange as a means of payment only if a bank known to the exporter guarantees the buyer's (the drawee's) payment obligation under the bill of exchange.

The guarantor signs the bill of exchange (on the face of it) and may add the statement "per aval for the account of the drawee".

Injunctions

When someone requests a court to issue an injunction to stop a payment – for example to prevent a guarantor from paying a sum of money it is obliged to pay according to the terms of its guarantee, the court will often require the petitioning entity that requested the injunction to provide a sum of money as collateral/security. Instead of providing cash, a court will often accept a guarantee as collateral.

Guarantee in consortium operations

In large international projects several contractors can be responsible for different parts of the contract. Usually a main contractor has subcontractors, possibly different sizes of businesses and different kinds of legal entities from several different countries, to deliver certain parts of a plant or to complete a part of the contract. The beneficiary may require security for the fulfilment of the whole project, and the main contractor may require security for the subcontractors' fulfilment of their obligations.

The main contractor has to determine whether it is willing to, or has to, carry the whole guarantee risk under the guarantee issued in favour of the beneficiary, and whether it wishes to require adequate security from its subcontractors.

Another possibility is that a subcontractor and/or a subcontractor's bank will provide separate security directly to the main contractor's bank in exchange for a certain part of the guarantee to be issued in favour of the beneficiary. This reduces the main contractor's need to assume the subcontractor's security as well as the risk.

Different forms of bank guarantees - specified by way of issuance

Standby letters of credit

Even though the standby letter of credit (hereafter "standby") has been known for many years, its use has gained ground only in recent years in the Nordic region and the rest of Europe.

As the name indicates, a standby takes the form of a documentary credit, while its function and content is that of a guarantee. It was developed in the US around a half a century ago when US banks were not allowed under US law to issue guarantees. By issuing a standby, banks were able to accommodate customers' needs for products that naturally belonged to the banking business.

Even though US legislation has since been modified, standbys still enjoy widespread use as a guarantee undertaking. At first the standby was primarily used in the US and in connection with business transactions relating to the US or countries whose banking systems were influenced by US banking practice. Today, however, standbys have gained popularity worldwide to the extent that the issuance of standbys by non-US banks is believed to outnumber issuance by US banks.

A standby can be defined as a demand guarantee assuming the shape of a documentary credit. As with the documentary credit, the beneficiary under a standby is to present documents in accordance with the stipulations of the standby (and UCP 600 or ISP98 as the case may be) in order to obtain payment.

Instead of requiring the presentation of shipping documents, the beneficiary under a standby must present a document stipulated in the standby, declaring that the applicant/instructing party has failed to fulfil its payment obligation, to perform a job or to meet some other commitment called for in the commercial contract and sometimes has also failed to state the manner in which the applicant/instructing party has not fulfilled its obligation.

The standby occasionally stipulates that the beneficiary's declaration must be accompanied by other documents supporting the demand, such as copies of invoices, transport documents or a statement of account. In most cases, these copies will not be examined for their correctness; they may only need to be presented.

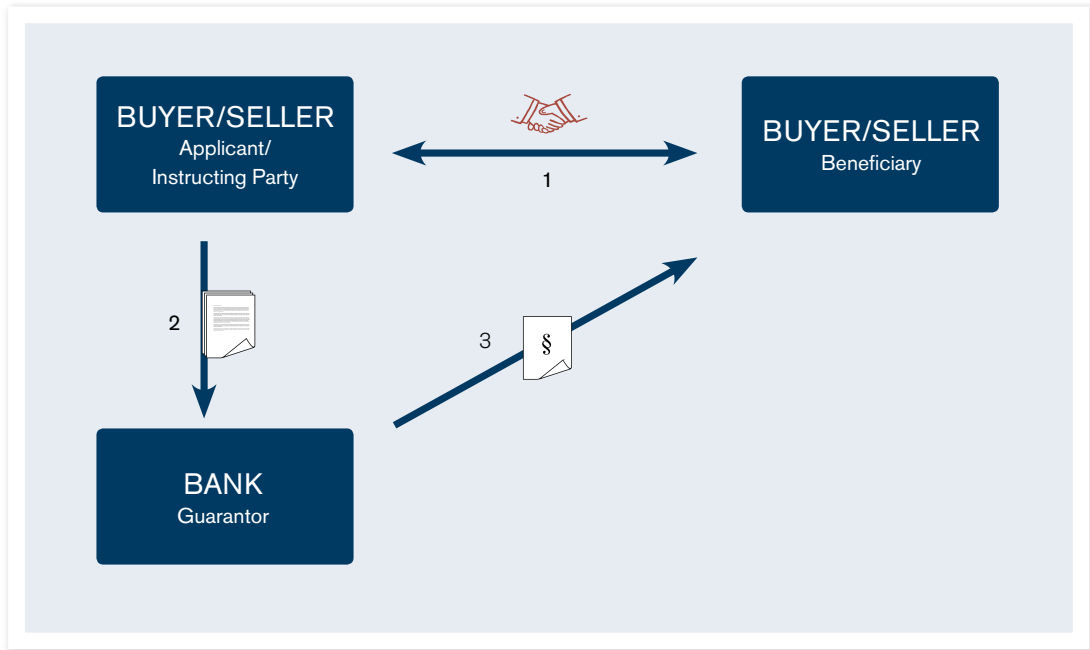
Like a guarantee, a standby is a very flexible instrument that can be used for all types of business. It can cover anything ranging from an ordinary guarantee commitment to more sophisticated financial instruments.

Originally standbys were issued subject to the UCP (*Uniform Customs and Practice for Documentary Credits*) version applicable at time of issuance. However, many bankers found that these rules – developed for documentary credits – did not fully accommodate the standby. For that reason, in 1998 the Institute of International Banking Law and Practice (IIBLP) drafted a new set of rules especially designed for standbys. These were entitled *International Standby Practices* (ISP98), and they came into effect on 1 January 1999. The ISP have been endorsed by the ICC Commission on Banking Technique and Practice, even though UCP 600 can still be used for standbys as well (UCP 600, article 1).

Direct guarantees

A direct guarantee is the most common way to issue a guarantee. The guarantee is issued by the guarantor directly to the beneficiary of the guarantee, and the beneficiary must present the demand for payment directly to the guarantor. Such a guarantee may be issued by letter or by telecommunications/SWIFT, for example.

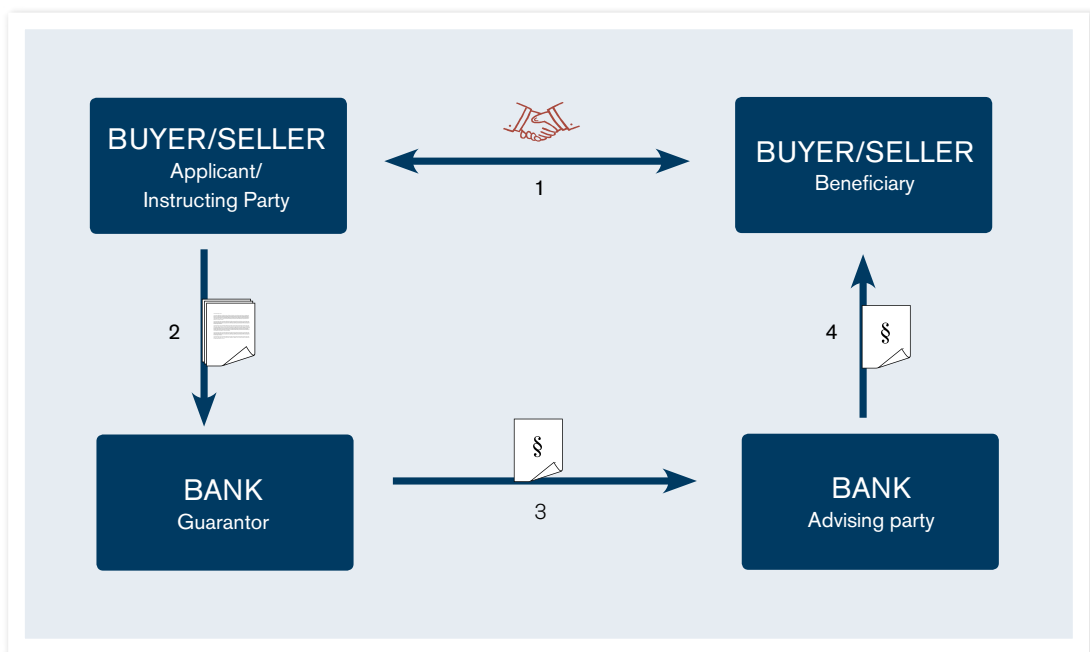
Figure 3



- 1) Agreement between buyer and seller
- 2) Guarantee application/counter indemnity (from applicant to the guarantor)
- 3) Issuance of the guarantee by the guarantor

A direct guarantee may also be advised through another party (often a bank). This party is called the “advising party”.

Figure 4



- 1) Agreement between buyer and seller
- 2) Guarantee application/counter indemnity (from applicant to the guarantor)
- 3) Issuance of the guarantee by the guarantor
- 4) Advise of the guarantee to beneficiary

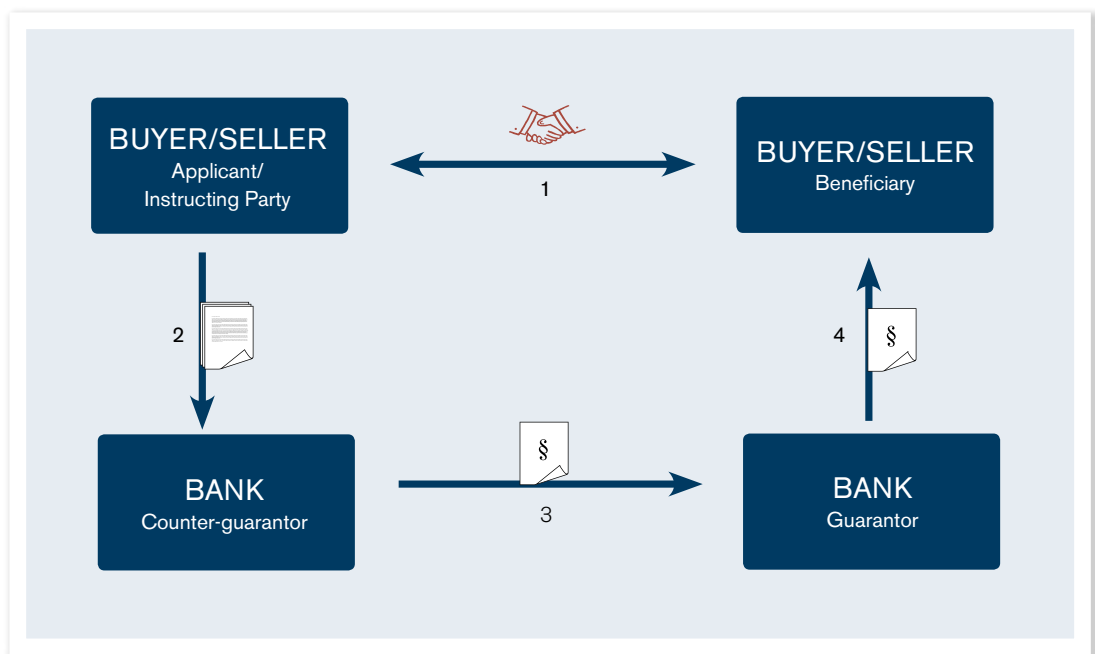
In this case the guarantee is issued by the applicant/instructing party's bank and forwarded to the beneficiary through its bankers (advising party), usually via **SWIFT** for authentication. The advising party is not obligated to the beneficiary under the guarantee. It serves as a kind of post office. (More on advising guarantees in Chapter 5.4 "Advising /amending the bank guarantee").

Indirect guarantees

An indirect guarantee is a guarantee under which the beneficiary of the guarantee receives a guarantee issued by a bank in its own country, usually its own bank, even though it is originally issued by the applicant/instructing party's bank. In the latter case it is called a "counter-guarantee".

In practice, the applicant/instructing party's bank issues the counter-guarantee to the beneficiary's bank, instructing that bank to issue its own guarantee to the beneficiary.

Figure 5



- 1) Agreement between buyer and seller
- 2) Guarantee application/counter indemnity (from applicant to the counter-guarantor)
- 3) Issuance of the counter-guarantee by the counter-guarantor
- 4) Advise of the guarantee to beneficiary

A counter-guarantee may be defined as:

“An undertaking given by the counter-guarantor to another party which names that party as the beneficiary to procure the issue by that other party of a local guarantee to be issued to the beneficiary in the underlying contract/relationship.”

It is important to note that there are two separate and distinct guarantees and that each provides payment upon the presentation of a complying demand.

If a complying demand is to be made under the local guarantee, the guarantor will present its demand under the counter-guarantee. This is common practice in many Middle Eastern countries, but elsewhere as well, especially when the beneficiary is a government entity.

In this case the counter-guarantor is obligated to the guarantor, and the guarantor is obligated to the beneficiary. As such, the counter-guarantor undertakes to reimburse the guarantor in the event a complying demand has been made under the guarantee. The guarantee issued by the guarantor to the beneficiary is also referred to as the “local” guarantee.

Rules, practices, laws and conventions

There are a number of regulations governing the world of guarantees. Some are set out by law, others are based on rules that are to be agreed to in order to apply and still others are based on international conventions, the purpose of which is to have them adopted by individual countries.

Below is an overview of the various rules, practices and conventions that exist for guarantees.

Rules and practices

More than one set of rules could govern a guarantee. In order for a guarantee to be subject to a specific set of rules, the guarantee must include a clear indication that it is subject to those rules. The current rules include:

URDG 758

The *Uniform Rules for Demand Guarantees* (2010 Revision) (ICC Publication No. 758). URDG 758 are rules to govern demand guarantees. They are effective as of 1 July 2010. They replace ICC's first set of guarantee rules, URDG 458.

ICC 325

Uniform Rules for Contract Guarantees

ICC 325 are ICC's rules for contract guarantees. They came into effect in August 1978. These rules have not been generally accepted by the market and consequently are rarely used.

ICC 524

ICC Uniform Rules for Contract Bonds

These rules came into effect in January 1994. They are rarely used.

ISP98

International Standby Practices (ISP98)

Developed by the Institute of International Banking Law and Practice, endorsed and published by ICC, ISP98 are the basic rules for the use of standby letters of credit worldwide. (See Chapter 2, Standby letters of credit)

UCP 600

Uniform Customs and Practice for Documentary Credits (2007 Revision) (ICC Publication No. 600). UCP 600 are universally used for commercial documentary credits but can also be used for standbys.

ICC Banking Commission Opinions

For educational purposes and to facilitate proper use of ICC rules (UCP, URR and URDG, Incoterms, as well as the ISBP), anyone can submit a query relating to ICC rules to the ICC Commission on Banking Technique and Practice (also known as the Banking Commission). In the case of Incoterms, queries should be submitted to the ICC Commission on Commercial Law and Practice. The Commissions' responses are called "Opinions" and are routinely published by ICC Business Bookstore.

DOCDEX Decisions

The ICC Banking Commission also offers a service called "DOCDEX" (short for Documentary Instruments Dispute Resolution Expertise). This is an expedited process for resolving disputes involving:

- a documentary credit, incorporating the ICC *Uniform Customs and Practice for Documentary Credits* (UCP), the application of the UCP and/or of the ICC *Uniform Rules for Bank-to-Bank Reimbursements under Documentary Credits* (URR);
- a collection, incorporating the ICC *Uniform Rules for Collections* (URC), and the application of the URC;
- a demand guarantee, incorporating the ICC *Uniform rules for Demand Guarantees* (URDG), and the application of the URDG.

The objective of DOCDEX is to provide independent, impartial and prompt expert decisions as to how the dispute should be resolved on the basis of the terms and conditions of the documentary credit, the collection instruction, the demand guarantee and the applicable ICC rules, (UCP, URR, URC or URDG).

The ICC charges a fee for handling cases under the DOCDEX system, and a submission will be subject to the ICC Rules for Documentary Instruments Dispute Resolution Expertise (the DOCDEX rules), which can be downloaded free of charge from the ICC website, www.iccwbo.org.

Law and jurisdiction

The commercial parties have the freedom to choose which law will apply to the contract. The same holds true for guarantees.

The law applicable to the guarantee need not be the same as the law applicable to the underlying relationship.

If the guarantee expressly stipulates the governing law applicable to the guarantee, and nominates a specific court, this law will then be applied and the nominated country will have jurisdiction. There is no room for different interpretations. URDG is the only set of rules that provides a default rule in this situation. Many guarantees do not stipulate the applicable law.

If the parties are using the URDG and if a guarantee does not state the applicable law/jurisdiction, then the applicable law and jurisdiction defaults to the country of the location of the guarantor's branch or office that issued the guarantee.

If the parties are using the URDG and if a counter-guarantee does not state the applicable law/jurisdiction, then the applicable law and jurisdiction defaults to the country of the location of the counter-guarantor's branch or office that issued the guarantee. In most cases, the guarantor and counter-guarantor are located in different countries, and only the counter-guarantor will have the benefit of a local court to settle any legal issues.

If the parties are not using the URDG, it is recommended that they insert a governing law and jurisdiction; however, unless this is agreed in the underlying contract/application, this insertion may cause the beneficiary to refuse the guarantee.

Conventions

The Rome Convention

The *Rome Convention on the Law Applicable to Contractual Obligations* was introduced in 1980 by the European Commission. Under this Convention, the parties may choose the law applicable to the contract. In the absence of a choice of law, the governing law is the law of the country where the provider of the characteristic performance has its place of business.

The UNCITRAL Convention

ICC is not the only organization engaged in drafting rules to ensure that guarantees are construed and handled as uniformly as possible.

A working party set up by the United Nations with representatives from countries worldwide has drafted rules and legislation for international guarantees. The result is the *United Nations Convention On Independent Guarantees and Stand-By Letters Of Credit*.

The Convention describes the basic principles of law for independent undertakings, aiming to revise their treatment in international trade. The Convention deals with independent undertakings which mean that it only apply to those cases where the guarantee agreement does not incorporate the terms of the underlying contract.

Amount and currency

Introduction

A guarantee must state the maximum amount and the currency for which the guarantor is liable. It must be clear from the guarantee the amount to which the bank's liability extends. The bank's pricing is based on the guarantee amount, which is the amount the instructing party is liable to pay for the guarantee's commission.

The amount for which the guarantee is valid is important for two reasons: first, it is the amount that the applicant/instructing party is liable to the guarantor if a complying demand is made; and second, it is based on that amount that the fees for the guarantor are calculated.

Sometimes the bank's liability extends to payment of interest in addition to the principal amount. For instance, in advance payment guarantees the bank may undertake to repay the advance payment plus interest. This may be expressed in clauses as follows: *"We undertake the repayment to you of the advance payment of plus interest thereon at the rate of 6% per year calculated from the date of receipt of the advance payment by the principal until the date of repayment of the same by us"*.

However, the principal rule is that the bank's liability only covers the guarantee amount unless otherwise stated in the guarantee text.

Reduction and increase of the guarantee amount

In most cases, the guarantee covers the amount it was issued for during its entire period of validity. However, it is possible for the guarantee amount to be reduced over time.

Since the guarantee is issued to secure the beneficiary's interests, a reduction of the bank's liability under a guarantee must be approved by the beneficiary.

This may take place either by a separate confirmation by the beneficiary or by including a reduction clause in the guarantee text.

Naturally, it would be in the interest of the instructing party to have the guarantee amount reduced in accordance with the progress of its performance under the underlying contract, for instance by presenting a certain document to the bank. This, however, makes the bank's position difficult. Before the bank releases in part the instructing party of its liability to the bank, the bank must be absolutely sure that the beneficiary approves the reduction of the guarantee amount.

As a consequence, if the guarantee text contains a reduction clause, it should be indisputable and clear. The simplest way to ensure this is for the guarantee text to stipulate a calendar date, after which the guarantee amount will be reduced to a lower amount. A sample clause to this effect could be written as follows: *“This guarantee remains valid for until (calendar date), and provided that no demand for payment has been presented to us on or before that date, this guarantee remains valid for the reduced amount of until ”*.

Unfortunately, it is not always possible to set a specific calendar date in this way. An alternative would be for the guarantee text to state that the guarantee amount will be reduced against *presentation* of a specified document signed by both the applicant/instructing party and the beneficiary or an independent third party.

Guarantees according to URDG 758

The following is an introduction to a guarantee that incorporates URDG 758. The first section describes the parties as defined in the rules, the second is a detailed, step-by-step outline of the demand guarantee process.

The parties involved in a guarantee transaction

A certain terminology is used in guarantee transactions, in particular when describing the parties to the transaction. The same party may have different names: for example “principal” is the same as “instructing party”. The following paragraphs show how the parties are defined in URDG 758.

Advising party

Advising party is defined as “*the party that advises the guarantee at the request of the guarantor*” (article 2). In a guarantee transaction, the advising party will often be either a correspondent of the guarantor or the bank that has a relationship with the beneficiary.

Applicant

Applicant is defined as “*the party indicated in the guarantee as having its obligation under the underlying relationship supported by the guarantee*” (article 2). In many cases, the applicant and instructing party are the same, but this need not be the case.

Note: this definition must be read in conjunction with the definition of “instructing party”.

Beneficiary

Beneficiary is defined as “*the party in whose favour a guarantee is issued*” (article 2). This is normally the counterparty of the applicant/instructing party with whom the applicant/instructing party has the underlying contract/relationship

Counter-guarantor

Counter-guarantor is defined as “*the party issuing a counter-guarantee, whether in favour of a guarantor or another counter-guarantor, and includes a party acting for its own account*” (article 2). In most cases, the guarantor is the bank of the applicant and/or instructing party. See Chapter 2, Indirect guarantee.

Guarantor

Guarantor is defined as “*the party issuing a guarantee*” (article 2).

In most cases, the guarantor is the bank of the applicant or instructing party.

Instructing party

Instructing party is defined as “*the party, other than the counter-guarantor, who gives instructions to issue a guarantee or counter-guarantee and is responsible for indemnifying the guarantor or, in the*

case of a counter-guarantee, the counter-guarantor” (article 2). In many cases, the applicant and instructing party are one and the same, but this need not be the case.

Presenter

Presenter is defined as “a person who makes a presentation as or on behalf of the beneficiary or the applicant, as the case may be” (article 2). When the beneficiary presents a demand directly to the guarantor, the beneficiary becomes the presenter.

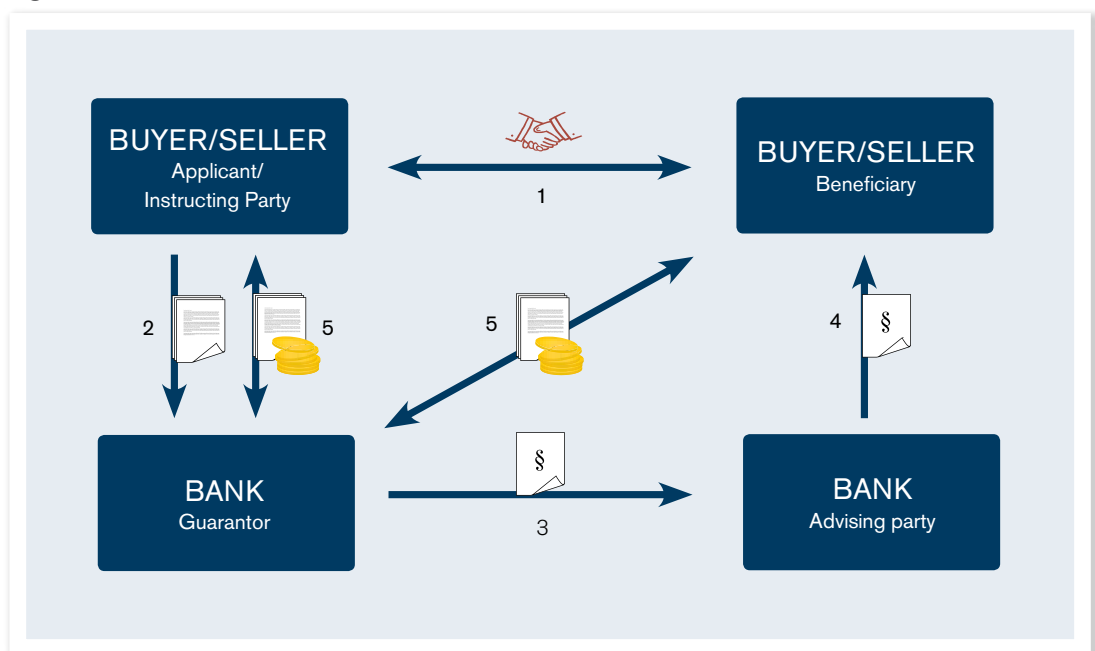
The steps of a URDG 758 guarantee

The following is a step-by-step walk through the process of a demand guarantee issued subject to URDG 758. This guarantee transaction which is used to exemplify the use of guarantees is a standard demand guarantee issued by a guarantor on behalf of an applicant/instructing party. Other guarantee structures will be described as well where appropriate.

It should be noted that in most cases demands are not made under the guarantee, meaning that only points 1–4 below will apply.

One advantage of URDG 758 is that they include rules for the other aspects of the guarantee process as well. For that reason, these are also included here.

Figure 6



- 1) Agreement between buyer and seller
- 2) Guarantee application/counter indemnity (from applicant to the guarantor)
- 3) Issuance of the guarantee by the guarantor
- 4) Advise of the guarantee to the beneficiary
- 5) Demand/Presentation/Payment under the guarantee

This process is described in detail below. The numbers mentioned in Figure 6 are identical to those below.

1) Agreement between the parties

It is the applicant/instructing party that sends an application for the issue of a guarantee to its bank. The application should be based on the agreement with the applicant/instructing party's counterpart, who becomes the beneficiary of the guarantee.

This agreement (outlined in a contract, proforma invoice, etc.) should preferably include information about the guarantee(s) to be issued. It is important to bear in mind that this is the information that will be included in the final guarantee. Therefore, it is important that it reflects the agreement made and that it be clear and precise. See No 2 below for the information that should be included.

2) Guarantee application

When the contract is concluded, the next step is to apply for issuance of the guarantee. Most banks have dedicated application forms especially for this purpose. The applicant/instructing party fills in all relevant facts that should be included in the guarantee, such as beneficiary, amount and required documents, etc. This should reflect what has been agreed in the contract.

All instructions for the issuance of a guarantee and the guarantee itself should be clear and precise and avoid excessive detail (article 8).

It is recommended that at least the following be included in a guarantee (article 8):

- applicant;
- beneficiary;
- guarantor;
- a reference number identifying the underlying relationship;
- a reference number identifying the issued guarantee;
- the amount and currency payable (for currency see article 21);
- the expiry of the guarantee;
- the terms for demanding payment;
- in what form a demand or other document shall be presented, i.e. in paper and/or electronic form;
- the language of any document specified in the guarantee; and
- the party liable for the payment of any charges (for charges see article 32).

Information concerning the names and addresses of the applicant/instructing party and the beneficiary must be complete and correct. It should be clear which obligation the guarantee covers and who is entitled to make a demand under the guarantee. This is of particular importance for companies operating under several names and with independent units that may be separate legal entities.

Obviously, it is essential that the amount of the guarantee and currency be correctly stated.

If the guarantee is to cover interest or expenses in addition to the principal amount, these must be explicitly stated.

In addition, the parties should consider which bank should issue the guarantee. When receiving the guarantee, one could say that the beneficiary “transfers” a defined risk (e.g. of non-performance or non-payment) from the applicant/instructing party to a guarantor (often a bank). It is therefore important to indicate which bank will do the issuance.

As described under *Definition and purpose of a bank guarantee* (Chapter 1), the guarantee is a “documentary instrument” in the sense that presentation of a complying demand must be made to the guarantor in order to trigger the obligation to pay. For that reason, it is important that the guarantee clearly specifies the documents to be presented when demanding payment under the guarantee.

The application may also include information concerning how the guarantee is to be advised to the beneficiary (see Chapter 4, 3)).

The application also serves as the agreement between the guarantor and the applicant/instructing party for the issuance of the guarantee. Therefore, the application also contains General Terms and Conditions under which the bank is prepared to issue the guarantee. The application must also be duly signed by the applicant/instructing party (this may be an electronic signature). In many cases, for example when the application is sent electronically, the General Terms and Conditions may be agreed via a general agreement between the customer and the bank covering all guarantees issued.

It is important to bear in mind that because this application is the basis for the guarantee the information in it also should be clear and precise. The applicant/instructing party is committed to the guarantor according to the information in the application. The guarantor is bound by the terms and conditions stated in the guarantee vis-à-vis the beneficiary, while all the terms and conditions stipulated in the trade agreement are a matter solely between the buyer and the seller.

If a specific guarantee text has been agreed by the parties, it should be attached as an appendix to the application.

The guarantee application will also be the place where the applicant/instructing party chooses which rules should apply to the guarantee. In order for URDG 758 to apply, the guarantee must expressly indicate that it is subject to these rules (article 1(a)).

3) Issuing the bank guarantee/amendment

The issuance of the guarantee by the guarantor is based on the application received from the applicant/instructing party.

The guarantor will only issue the guarantee after having checked and accepted the application form.

The issuance of the guarantee may take place in a number of ways, for example through SWIFT via an advising party, but it may also be issued in paper format and handed over to the instructing party for further delivery to the beneficiary, or sent directly to the beneficiary according to the instructions received.

An amendment (change to an existing guarantee) is either requested by:

- 1) a signed letter from the applicant/instructing party or
- 2) a bank's amendment request application.

When the guarantee leaves the control of the guarantor, it is issued (article 4(a)) and irrevocable (article 4(b)). This means that an amendment made without the beneficiary's agreement is not binding on the beneficiary (article 11(b)).

An amendment should be routed through the same parties as the original guarantee (article 10(f)).

Note that an amendment made without the beneficiary's agreement is not binding on the beneficiary (article 11(b)) before the beneficiary has accepted all aspects of the amendment. Partial acceptance of an amendment will result in refusal of the whole amendment (article 11 (e)).

4) Advising/amending the bank guarantee

When advising the guarantee the advising party will check its apparent authenticity and will be responsible for ensuring that the advice sent to the beneficiary accurately reflects the terms and conditions of the guarantee received (article 10(a)).

Immediately on receipt of the guarantee, the beneficiary should examine it to make sure that it is in accordance with the contract or any other agreement, and that it will be possible to comply with all of its terms and conditions if a demand for payment is to be made.

5) Demand/presentation/payment under the bank guarantee

The purpose of most guarantees is to serve as security. In a perfect world, demands will not be made under the guarantee, and it will simply expire unutilized as the commercial parties each perform as they are supposed to according to the commercial contract.

However, in some cases it will be necessary to make a demand under the guarantee. When this occurs, URDG 758 has a number of provisions to regulate the process.

Demand/presentation

URDG 758 makes a distinction between demand and presentation (article 2). A demand is a demand for payment, while a presentation is to be understood in a broader sense and may also serve other purposes: for example presentation of a document reducing the amount of the

guarantee. In other words, a demand is always a presentation, but a presentation is not always a demand.

The presentation must be made to the guarantor at the place where the guarantee has been issued or a place stated in the guarantee. The presentation must be made on or before expiry (article 14(a)).

It is also important that the presentation identifies the guarantee under which the presentation is made. This will normally be done by stating the guarantor's reference number of the guarantee. In case there is no such identification, the examination of the demand will only begin after this identification has been made.

If the examination of the presentation is delayed because of problems with identification, this does not mean that the expiry of the guarantee is extended (article 14(f)).

Examination of the presentation

When a presentation is made to the guarantor, it will be examined in order to determine if it is in compliance with the requirements set out in the guarantee. If it is a complying demand, this obligates the guarantor to pay the beneficiary.

The examination is based solely upon the documents presented; in this respect, it is important that the examination be based upon the documentary requirements expressed in the guarantee, since non-documentary conditions are generally disregarded (article 7).

For example, a requirement such as: *“This guarantee will expire once the plant has been successfully installed at the site of the applicant”* is a non-documentary condition. However, while guarantors may disregard this condition for document examination purposes, this does not mean it will be disregarded when it comes to performance of the parties under the guarantee.

The example above relates to dates or the lapse of a stated period, i.e. statements that trigger an event by a determinable date or specified period. Another example concerns conditions/events that may increase or decrease the amount of the guarantee, for instance: *“The guarantee will automatically be reduced by USD 50.000 on 1 July 2011 unless a complying demand has been made to the guarantor on or before that date”*. This condition, while non-documentary, still remains a term of the guarantee that must be adhered to. Likewise, the fulfilment of a stated requirement that can be determined from the guarantor's own records, i.e. the reduction of the guarantee amount based on a payment transfer from the applicant's account held with the guarantor is a non-documentary condition that must be adhered to, even though it may be disregarded during the examination process.

Note that a required document cannot contain information that conflicts with the guarantee's terms. This also applies to non-documentary requirements.

While it is expected that each guarantee will contain all the documents necessary to fulfil a complying demand, URDG 758 includes a common, best practice default requirement that a statement (supporting statement) must be provided by the beneficiary, indicating in what respect the applicant is in breach of its obligations under the underlying relationship (article 15(a)). This provision is only effective should a guarantee not be issued in accordance with the standard format and if it is silent with regard to the beneficiary's requirement to provide a demand's supporting statement.

The examination by the guarantor will be made on the basis of the presentation alone, whether it appears on its face to be a complying presentation (article 19(a)). This examination is independent of the underlying relationship. It is important to note that the guarantor will compare data within and between documents and with data in the guarantee in accordance with "international (not local) standard guarantee practice". The data need not be identical to, but must not "conflict" with other data or the guarantee (article 19(b)). For example, if a guarantee states that it covers a shipment of *shirts* sizes s-xxl and a required demand document shows that *skirts* sizes s-xxl were shipped, this would be a basis to determine that the demand presentation is not a complying one.

Time for examination, payment and rejection

When a demand is made to the guarantor, the guarantor shall, within five business days following the day of presentation, examine the demand and determine if it is a complying demand (article 20(a)).

The guarantor has some obligation to inform the instructing party of the demand under the guarantee (article 16); however this, in itself, does not give the instructing party any right to reject the demand. Any payment or rejection will be based only on the examination of the demand by the guarantor.

In the examination process there are three possible scenarios:

a) It is a complying demand

When the guarantor determines that it is a complying demand it must pay under the guarantee (article 20(b)).

As noted above, the instructing party should be informed about the demand. In addition, the guarantor must send copies of the complying demand to the instructing party (article 22). However, the payment obligation is triggered by the demand made to the guarantor; if it is a complying demand, the guarantor has an obligation to pay the beneficiary, and the instructing party is obligated to pay the guarantor based on the guarantee application.

b) It is a non-complying demand

If the demand is not a complying demand, the guarantor may reject the demand. It also has the option to contact the instructing party for a waiver of the discrepancies noted (article 24(a)).

If the guarantor rejects the demand, this must be done in accordance with the provisions set out in article 24. In this respect it should be noted that the rejection must be sent without delay, but no later than the closing of the fifth business day following the day of presentation (article 24(e)).

c) The demand is not rejected within five business days from its date of presentation

The consequences of not making a timely rejection can be onerous. In such a case, the guarantor is precluded from claiming that the demand does not constitute a complying demand (article 24(f)). In other words, if a rejection of a demand for payment has not been sent by the close of the fifth business day following the day of presentation, the guarantor is obligated to pay!

Extend or pay

If the beneficiary alleges that the applicant will or has not been able to fulfil its contractual obligations and the guarantee is about to expire, the beneficiary may present an “extend or pay” demand to the guarantor. Such a demand provides the guarantor with an alternative, namely to extend the expiry of the guarantee or pay the complying demand. This situation is covered in URDG 758 article 23.

The prerequisite for this is that a complying demand has to have been presented to trigger the guarantor’s obligation to pay.

If a demand is complying, the guarantor may suspend the payment for a period not to exceed 30 “calendar” days (article 23(a)) and shall inform the instructing party of the suspension (article 23(c)).

It is the sole choice of the guarantor whether or not to grant the extension request, but if an agreed extension is not provided, the guarantor (or counter-guarantor) must pay the demand (article 23(e)).

This process gives the beneficiary an opportunity to negotiate and the flexibility either to prolong the guarantee’s validity or to receive payment.

It is usually in the interest of the guarantor to negotiate an extension with the beneficiary (hence the 30-day suspension rule described above), and if no agreement can be reached, to make sure that the beneficiary is paid and the guarantee is cancelled. The extend or pay demand may cause the guarantee to be extended several times, at the discretion of the beneficiary (and the guarantor), and it can significantly increase the cost of the guarantee to the instructing party.

6) Expiry of the guarantee

A guarantee should include information about its expiry. The expiry may be expressed in the guarantee either as a specific expiry date or as an expiry event (article 2).

In the case of an expiry event, it is important that the guarantor be able to determine when that event occurs, either based on a document presented to the guarantor or an event that can be determined from the guarantor's own records (for example an indication that the transfer of a certain amount of money from the applicant to the beneficiary has taken place).

If the guarantee includes an expiry date and an expiry event, the earlier of the two is deemed to be expiry.

A presentation under the guarantee must be made on or before expiry (article 2).

URDG 758 has a special provision concerning expiry, namely that if the guarantee states neither an expiry date nor an expiry event, the guarantee shall terminate after the lapse of three years from the date of issue (article 25).

It is important to note that when using an expiry event and anticipating expiration later than three years after the event, the procedures and conditions to deal with this eventuality should be clearly stated and understood.

If a guarantee does not state an expiry date or event and is not subject to URDG 758, then local law will determine when the expiry occurs.

Although it is not recommended, there are situations in which the guarantee will not include information about its expiry, for example guarantees in favour of customs offices, tax or other authorities. For this kind of guarantee, it is essential that the applicant ensure that the guarantee document is returned to the bank, or that the bank is otherwise released by the beneficiary when the guarantee is no longer needed.

Appendix

Definition of bank guarantee terms

Term	Reference	Description
(guarantee) Application	URDG 758 article 2	The request for issuance of a guarantee
Complying demand	URDG 758 article 2	A <u>demand</u> made under a guarantee that meets the requirements of a <u>complying presentation</u>
Complying presentation	URDG 758 article 2	A <u>presentation</u> under a guarantee that is in accordance with 1) the terms and conditions of the guarantee, 2) the URDG 758, and 3) international standard demand guarantee practice
Demand	URDG 758 article 2	A document signed by the beneficiary demanding payment under a guarantee
Expiry	URDG 758 article 2	Either the expiry date or the expiry event or, if both are specified in the guarantee, the earlier of the two. Presentation under a guarantee must be made on or before expiry.
Expiry date	URDG 758 article 2	The date specified in the guarantee on or before a <u>presentation</u> may be made
Expiry event	URDG 758 article 2	An event which, under the terms of the guarantee, results in its expiry, whether immediately or within a specified time after the event occurs, for which purpose the event is deemed to occur only: 1) when a document specified in the guarantee indicating the occurrence of the event is presented to the guarantor, or 2) if no such document is specified in the guarantee, when the occurrence of the event becomes determinable from the <u>guarantor's own records</u>
Guarantor's own records	URDG 758 article 2	The records of the guarantor showing amounts credited or debited to accounts held with the guarantor (provided the record of those credits or debits enables the guarantor to identify the guarantee to which they relate)
Issuing bank		Another word to describe the entity issuing a guarantee. In this publication this party is called "guarantor".
Presentation	URDG 758 article 2	The delivery of a document under a guarantee to the guarantor or the document so delivered. It includes a presentation other than for a <u>demand</u> , for example presentation for the purpose of triggering the <u>expiry</u> of the guarantee or a variation of its amount
Principal		In URDG 458 this was the word used to describe the applicant. In URDG 758 this party was replaced by the "applicant" and "instructing party". In this publication this party is called the "applicant/instructing party".

Term	Reference	Description
Supporting statement	URDG 758 articles 2 and 15	A statement by the beneficiary indicating in what respect the applicant is in breach of its obligations under the <u>underlying relationship</u>
SWIFT		SWIFT (Society for Worldwide Interbank Financial Telecommunication) has its headquarters in Brussels and was founded by and is still owned by banks in many countries. Its function is to provide an electronic network connecting the participating banks (and companies). The infrastructure is based on standardized messages and a high degree of security.
Underlying relationship	URDG 758 article 2	The contract, tender conditions or other relationship between the applicant and the beneficiary on which the guarantee is based.

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