

**Newsletter No 62 (EN)**

**Demand Guarantees  
and  
Unfair Calling of Guarantees**  
August 2009

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## Demand Guarantees and Unfair Calling of Guarantees

### 1. Introduction

In international trade, importers are particularly exposed to the risk that the other part, the exporter, will not be able to perform its contractual duties. Besides the *commercial risks* of insolvency and protracted default, the exporter may become incapable of performing its duties due to the risks attached to selling to public or private entities in territories, where political factors may have an impact. Such *political risks* are e.g. the cancellation of import or export licenses, the imposition of embargos or frustration of contract due to war or confiscation.

Importers in international trade therefore often wish to have a security that the exporter will perform his obligations. In order to secure the contract, an exporter may be required to provide a guarantee that takes the form of a *demand guarantee*. Whereas a *letter of credit* (L/C) would provide security for the exporter against non-payment, a *demand guarantee* provides protection to the importer against non-, late or defective performance by the exporter or contractor. Many contractors issue guarantees in the form of tender guarantees (also “bid guarantees”), advance payment or stage payment guarantees, performance or retention bonds.

The following newsletter is meant to give a short overview on the characteristics and risks of demand guarantees.

### 2. Nature and Features of Demand Guarantees

A *demand guarantee* is a contract by which a guarantor, usually a bank or other financing institution, undertakes to pay to the importer a sum of money up to the maximum quoted on the *demand guarantee* upon representation of a demand together with any other documents specified under the terms of the bank's guarantee.

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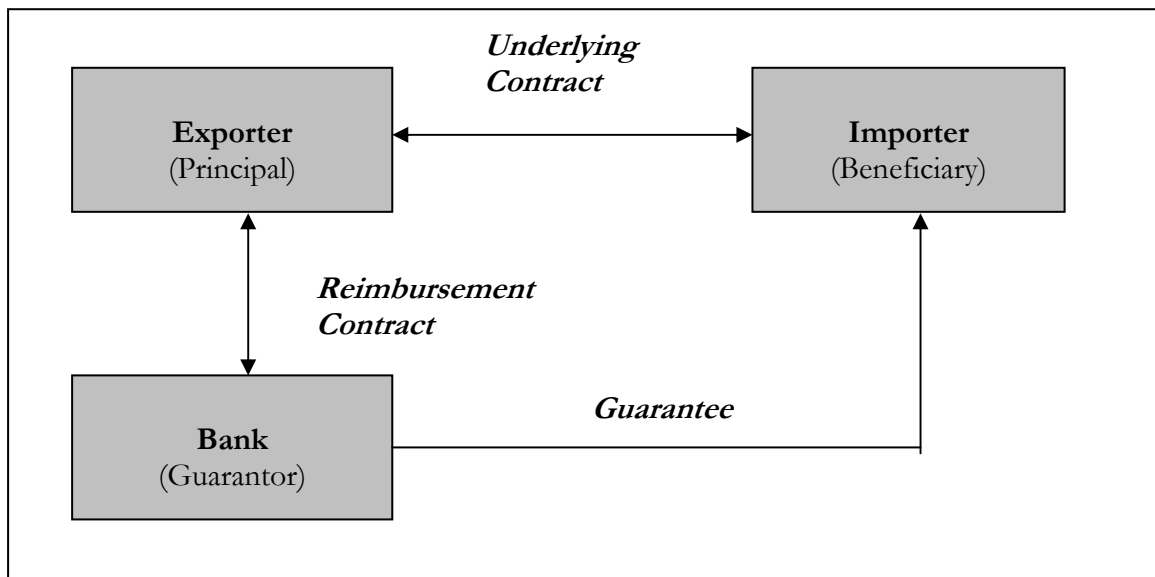
### 2.1 The Contractual Relations: Direct and Indirect Guarantees

A *demand guarantee* can be issued as a *direct* or *indirect guarantee*. Whereas in the constellation of a *direct guarantee* three subjects are involved, there are four subjects engaged in an *indirect guarantee*.

A *direct guarantee* is provided by the exporter's bank to the importer (beneficiary) directly. In this case there are three contracts:

- (1) The underlying contract between the exporter (principal) and the importer, that may be a sales contract or a contract for services,
- (2) the reimbursement contract between the exporter and his bank (under German law this usually is a "Geschäftsbesorgungsvertrag") and
- (3) the actual *demand guarantee* between the bank and the importer (under German law this is an "Abstraktes Schuldversprechen").

The structure of the contractual relations in a *direct guarantee* can be seen in the following diagram:



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In the case of an *indirect guarantee* the guarantee is provided by the importers own bank. The exporter's bank (instructing bank) instructs the importer's bank (issuing bank) to issue the guarantee in favour of the beneficiary. It is the issuing bank only that assumes the obligations of the guarantor. It does not act as an agent of the instructing bank. In this case there are four contracts. There neither is a contractual relationship between the beneficiary and the instructing bank nor between the exporter and the issuing bank.

### 2.2 Legislation Governing Demand Guarantees

The characteristics of a *demand guarantee* depend on the applicable legislation and jurisdiction. Normally, a bank guarantee will contain a provision stating the choice of law. In absence of such provision, conflicts of law provisions will most often provide that the location of the bank's office will be the decisive criterion regarding the applicable law, since the bank renders the characteristic main service.

In addition to the national law, the International Chamber of Commerce (ICC) has published several sets of rules concerning demand guarantees that can be referred to in demand guarantees as well: The "Uniform Rules for Contract Guarantees" of 1978 (Publication No. 325) did not gain wide acceptance. The "Uniform Rules for Demand Guarantees" (URDG, Publication No. 458) were issued in 1992. Although not used very frequently, it is to be recommended to use them in international contracts since these rules state the most common and widely used practices in international trade.

Under German law and the URDG, the main feature of a *demand guarantee* is that it is legally independent from the underlying contract between the exporter and the importer, i.e. it is an abstract payment undertaking.

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In general, payment must be made upon calling of the guarantee, e.g. on presentation of a written demand that complies with the provisions of the *demand guarantee*. Many demand guarantees are payable on first demand without any additional documents (so-called first demand guarantees). This reflects their origin in replacing cash deposits. However, also first demand guarantees ever more require at least a statement indicating that the exporter is in breach of contract (although this is contradictory to their nature).

### 3. Special Risks of Demand Guarantees: Unfair Calling and Expiration

There are two major risks inherent in demand guarantees: Unfair calling of the guarantee and the absence of an expiration date of the guarantee.

#### 3.1 Unfair Calling

Since the *demand guarantee* is legally separate from the underlying contract, it contains the risk of being called in unfairly when its conditions have been met. The URDG does not contain provisions regarding this case. Therefore, it depends on the jurisprudence and the legislation of the applicable national law in which cases a payment is regarded to be unfairly, giving the exporter a chance to prevent the bank from paying out the guarantee sum. Under German law, the exporter might successfully seek a remedy called "Einstweilige Verfügung" (provisional injunction) against the bank. However, under German law the injunction will only be issued in case the beneficiary misuses its position.

#### 3.2 Expiration

A clear expiry date should be stated in the *demand guarantee*. The URDG contain a set of expiry provisions. A standard clause is: "This guarantee shall expire,

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even if this document is not returned, on ... at the latest." However, some countries, especially in the Middle East, may not accept a *demand guarantee* which includes an expiry date as this may not be enforceable under local laws.

### 4. Insurance

The risk of unfair calling (as well as of fair calling, e.g. where the contract would not be performed for political reasons, such as non-renewal of export licenses) may be insured. The insurers range from national export credit agencies to private insurers. Although unfair calling of a guarantee does not occur very often, in certain cases it may be recommendable to seek insurance coverage.

### 5. Summary

Special prudence should be exerted when drafting the *demand guarantee*. Critical circumstances are the expiration of the guarantee and its legal separation from the underlying contract. Especially when doing business in regions where the performance of a contract depends on political impact, it might be recommendable to effect an unfair calling insurance.

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