DEMAND GUARANTEES ISSUED BY BANKS AND THE ASSOCIATED RISKS.

Guarantees are a vital component in international trade contracts. They play a major role in the field of construction contracts. The purpose of a guarantee is to offer an easily realizable assurance of payment from a reliable paymaster usually a financial institution, to safeguard the beneficiary in the event of non performance, late or detective performance by the contactor or supplier. These guarantees are typically used in construction contracts and contracts for domestic and international sale of goods and services.

In common law a guarantee is simply a deed by which one person, the guarantor, (often called the “obligor”) binds himself to another (the creditor/beneficiary, often called the “obligee”) for the payment of a specified sum at some future date or upon the happening of some particular event.

Guarantees may be termed depending on the degree of ease with which the creditor/beneficiary can call for payment. Contract guarantee/surety bond promises to be liable for the debt of similar obligation of another, that it is accessory

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Tender Guarantees (Bid Bonds)
Tender Guarantees are submitted for a specified percentage of the value of the underline transaction to safeguard the beneficiary against failure of the successful applicant to sign the contract and to furnish requisite performance or other kind of guarantee as required in the tender documents. It is to compensate the beneficiary from the trouble and expense he would suffer in re-awarding the contract and recover any other cost due to this failure.

PERFORMANCE GUARANTEE
A Performance Guarantee is issued for a specified percentage of the contract sum. It may be issued as a single guarantee to cover all phases of the contract or issued to cover distinct segments of the contract. In case of a single guarantee to cover all phases, the normal liability is not reduced in accordance with the claims honoured at each stage, unless a pro rata reduction of the liability is stipulated in the guarantee.

ADVANCE PAYMENT GUARANTEE
This guarantee is designed to secure the beneficiary's right to recover the advance given in the event principal has failed to perform the contractual obligations relating to the advance

RETENTION GUARANTEE
In construction contracts, the employer usually retains a specified percentage of money for a given period, from each stage of payment as a safeguard against defects. Retention guarantee enables the principal to get the release of the full payment in each stage, as it covers the beneficiary from any loss that could cause due to defects found later.

MAINTENANCE GUARANTEE
As in the case of retention guarantees, this guarantee covers the beneficiary from any defects or damages which comes to light during a stipulated period of time after completion of the contract, making it possible for the principal to get the release of full payment on completion.

SHIPPING GUARANTEES
Shipping Guarantees are issued by countersigning an indemnity issued by the importer to the shipping company in the absence of the original bill of lading. It is issued to avoid payment of demurrage and to clear the goods early in case of a delay in receiving the original bill of lading & to enable the shipping company to issue a delivery order as required under the contract of carriage. Considering the nature and the legal effect of this guarantee it is of a primary liability as in the case of an indemnity.

CUSTOMS GUARANTEE
It is generally used by the exporters who import textile or other primary goods to process and re-export, to have and arrangement with the customs to release the goods without payment of customs duty. The principal should produce documentary evidence of re-export to the customs within the validity period in order to get himself released from the liability of payment of customs duty and avoid any claims under the guarantee.

STAND BY LETTER OF CREDIT
The Stand by letters of credit originated in USA as a payment undertaking in the event of default by the principal under an underlying contract. Since banks in USA are normally not permitted to issue guarantees, this form of undertaking was adopted and brought within the ambit of the UCP instead of URDG. However ICC has later introduced a separate set of rules known as International Standby Practices (ISP) solely to cover stand by letters of credit.

The operation of these credits gradually developed to apply other practices widely used in documentary credit operations such as confirmation by a second bank, payment otherwise than at the counters of issuing bank, etc. The stand by letters of credit are also used as an all purpose financial support instrument such as to provide credit enhancements for primary financial undertakings, covering much wider range than a normal demand guarantee.

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KEY ELEMENTS OF A DEMAND GUARANTEE

Depending on the type of guarantee the terms and' contents of a demand guarantee vary considerably although key elements remain same in most of the guarantees.

In a bank guarantee there are at least three main parties. They are the party who issues the guarantee in this case the bank (1 - The issuer / guarantor), the party who requests issuance of the guarantee who is generally the customer of the bank (2 - The Principal), and the party for whose benefit the guarantee is issued (3 - The beneficiary). In the case of an International guarantee or in a counter guarantee there is another party called Instructing Party who enters into a contractual obligation with the Principal.

Some of the other key elements are made reference to the underlying contract, amount of the guarantee, currency of payment, documents to be presented with the claim, date of issue, date of commencement of the guarantee and the date of expiry of the guarantee.

PAYMENT ON DEMAND

In the case of a demand guarantee the guarantor will be liable to pay upon first written demand by the beneficiary, as in all demand guarantees will usually contain a clause that payment under the guarantee will be made upon the first written demand either with or without any supporting documents as stipulated in the text of the guarantee. The autonomy principal is at the core of bank guarantee operations as the bank guarantee transaction remains autonomous from the underlined contract between the principal and the beneficiary although its origin is based on the underlined contract. The only exception is where there is a fraud of which is very clearly established beyond doubts and the bank has notice of such fraud. It is certainly not enough to give notice of an allege fraud and expect the bank to check whether those allegations are well founded or not. It is not the role of a bank to examine the merits of allegations or place the bank in a position to act as courts in deciding whether to make a payment or not.

Once the beneficiary calls (submit a claim) upon the guarantee, issuer is not concerned of any disputes between the principal and the beneficiary as long as demand confirms to the terms and conditions of the instrument. The guarantor is not responsible for the adequacy, accuracy or genuineness of documents presented to make a demand under a guarantee. His duty is limited merely for ascertaining whether they appear on their face to confirm to the stipulated requirements of the guarantee and to exercise of good faith and reasonable care in performance of his duties. He is not answerable for acts outside his control.

This principle is illustrated in Edward Owen Engineering Ltd v Barclays Bank International Ltd & Umma Bank (1978). The court referred to the similarities with letters of credit, where the only exception to the strict rule of no interference would be if the bank knew that the request for payment was made fraudulently, or on forged do

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