Bank Guarantees
On the following pages we shall go into more detail presenting the various parties in a guarantee transaction and the relationships between them, a number of common terms used and some of the legal aspects.

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Bank guarantees – a short introduction

The bank guarantee is an instrument which business partners can use to strengthen and/or secure an obligation in their contract. The Principal - the party who requests that the guarantee is issued - applies to his bank for a bank guarantee to be issued in favour of the Beneficiary – the party who will receive the guarantee.

After examining and approving the Principal’s application, the bank draws up a contract with the Principal - the Counter-Indemnity. The Counter-Indemnity states, among other things, the rights and obligations of the Principal and the bank in relation to possible payment for claims under the guarantee. Once all of this is in place, the bank then issues the guarantee.

By issuing the guarantee the bank offers a security to the Beneficiary that is separate from the Principal’s ability or will to fulfil his part of the contract. For example, a guarantee can be issued to secure the repayment of an advance payment if delivery does not take place.

Bank guarantees can also be used to secure performance under a contract. Such a guarantee does not however mean that the bank completes the project in the event of non-performance. Instead the bank’s undertaking is a payment obligation. Funds are then available to the Beneficiary to enable him to, for example, complete the project with another party.

In general banks issue two different kinds of guarantees: Accessory and Non-Accessory guarantees.

Bank guarantee overview

Guarantees can be divided into two kinds – those that are linked to the underlying contract – an accessory relationship, and those that are independent or a non-accessory relationship. The former are often referred to as “Borgen” in Sweden. The latter category can be broken down further into Demand Guarantees and Standby Letter of Credit.

Obligations in an accessory guarantee

An Accessory Guarantee is dependent on the underlying contract, and the guarantor is entitled to invoke the defences which the Principal may have against the Beneficiary. In case of a dispute, the latter must prove his rights emanating from the underlying transaction. The bank has the same rights to object to a claim as the Principal, and the bank is only obliged to pay upon presentation of either a court decision or an arbitral settlement justifying the claim, or the Principal’s written approval of the claim.
Obligations in a non-accessory guarantee

With an Non-Accessory guarantee the main principle is “pay first – argue later”. From the Beneficiary’s point of view, this type of guarantee is often a better form of security. The Beneficiary has the best security if the demand guarantee is strictly unconditional (a simple demand) and contains no additional requirements such as documentation that must be presented to support the claim.

Direct guarantee v. indirect guarantee

A guarantee can be issued by the Principal’s bank either directly to the Beneficiary (a 3-part guarantee or direct guarantee) or through a bank in the Beneficiary’s country, (a local bank guarantee, a 4-part guarantee or an indirect guarantee). In the latter case, the Principal’s bank (the Instructing Bank) instructs a local bank (the Issuing Bank) to issue the guarantee in favour of the Beneficiary. As security, the Instructing Bank issues a counter-guarantee in favour of a local bank, entitling it to the right to submit a claim to the Instructing Bank in the event of payment of a claim.

The figure above shows the issuance of a direct guarantee.
With a direct guarantee, the Principal's bank issues the guarantee directly to the Beneficiary making this type of guarantee less expensive for the Principal as there are no foreign bank costs. Furthermore, the Issuing Bank has better control in the event of a claim under the guarantee, giving the Principal a certain amount of security. The Principal also has better control when the guarantee is eventually handed over to the Beneficiary.

Certain contracts may stipulate a guarantee to be issued by the Local Bank. This is even required by law in some countries and can be common market practice.

Beneficiaries may view the Local Bank guarantee as more secure, as they only need to deal with their own bank. Contact SEB for more information about what is applicable in your situation.

The figure above shows the issuance of a local guarantee.
Law and Jurisdiction

If a specific law is not mentioned in the guarantee then there are certain rules which may be used to determine which law should apply. Generally the law with the closest connection to the guarantee is applicable. For Accessory Guarantees that is normally the law applicable to the Issuing Bank. In the case of Non-Accessory Guarantees a court may be of the opinion that the underlying contract is of greater importance and rule that the laws applicable to that contract shall also apply to the guarantee. Consequently it is important to consider the choice of law and jurisdiction on a case by case basis.

The above diagram shows how a local guarantee is issued. In this scenario there are four separate and independent agreements i.e.
- the underlying contract
- the Counter-Indemnity
- the Counter-Guarantee
- the guarantee

In this situation if no law has been specified, problems can arise in the event of the Principal contesting payment of a claim under the guarantee. In the event of an unjustified claim - unfair calling - the bank has no case against the Beneficiary, but must instead pursue discussions with its direct contractual partner – the local bank. The local bank may have acted in complete compliance with the laws of its country, while Swedish legislation supports the Principal’s point of view, thus creating a conflict between the various parties involved.
The International Chamber of Commerce (ICC) has compiled several sets of rules for dealing with guarantees. By referring to the ICC rules in a guarantee you define a number of the different parties rights and obligations without having to specify them in the guarantee text, thereby reducing the risk of misunderstanding and creating a simplier text.

SEB recommends the use of the ICC rules and, in particular when applicable, the rules for demand guarantees URDG458 ICC Publication 458 and ISP98 ICC Publication 590.

Relation between the commercial transaction and bank guarantees

All guarantee types have a vertical arrow. The lower section of this figure shows the period for which the bank guarantees are usually valid. Note that the start dates for certain guarantees may differ (see the summary on page 9). It also gives an indication of the general size of the guarantee amounts, and demonstrates that this can, in some cases, be gradually reduced over time.
**Types of guarantees**

**Tender/Bid Guarantee**
Supports the Principal/Applicant’s obligation to execute a contract if the Principal/Applicant is awarded a bid.

**Advance Payment Guarantee**
Supports an obligation to account for an advance payment made by the Beneficiary to the Principal/Applicant. SEB recommends that an Advance Payment Guarantee contain a clause that the guarantee is inoperative until the Advance Payment has been received by the Principal/Applicant, as well as a clause allowing for reductions of the guarantee amount.

**Performance Guarantee**
Supports an obligation to pay for losses which may arise as a consequence of the Principal/Applicant failing to fulfill his obligations under the contract.

**Retention Guarantee**
Supports an obligation to account for retention money paid by the Beneficiary to the Principal/Applicant. SEB advises that the Retention Guarantee explicitly stipulates that it does not come into effect until the retention money has been received by the Principal/Applicant.

**Warranty Guarantee**
Supports the Beneficiary’s costs should the Principal/Applicant fail to meet his warranty obligations as per the contract terms.

**Payment Guarantee**
Supports the payment obligation of the Beneficiary for goods/services delivered by the Principal/Applicant.

**Loan Guarantee**
Supports the repayment of a credit or credit facility including amortisation and interest. The guarantee applies from the date the loan is made until it has been repaid.

**Bill of Lading-/Steamship Guarantee**
Supports the shipping company for any financial damages caused by the goods being delivered without the bill of lading. The guarantee is valid until the bill of lading is presented, or until the shipping company releases the bank from its liability.

**Maintenance Guarantee**
Supports remedies and any defects which become apparent after delivery of the goods or after completion of a plant.
What should a bank guarantee contain?

Ideally the underlying contract should contain clauses regarding how the guarantee(s) should be issued. All instructions for the issue of guarantees should be clear, precise and avoid excessive detail. Listed below are a number of the different points which can be contained in the various guarantee types. Note: most of these points should be mandatory, others will depend on the type of guarantee involved.

**A definition of the parties involved**
Direct Guarantee (3-part) Principal, Issuing bank and Beneficiary, Indirect Guarantee (4-part) Principal, Instructing Party, Issuing bank and Beneficiary.

**A reference to**
The underlying transaction requiring the issue of the guarantee.

**The guarantee amount**
The maximum amount payable and the currency in which it is payable.

**The period of validity**
Guarantees should expire on a specific date (“expiry date”) or on presentation to the Guarantor of the document(s) specified for the purpose of expiry (“expiry event”). If both an expiry date and an expiry event are specified in a guarantee, the guarantee shall expire on whichever of the two occurs first, whether or not the guarantee and any amendment(s) thereto are returned.

**Documentation**
Any demand for payment under the guarantee should be in writing and in addition to other documents which may be specified in the guarantee, for example, a certificate by an architect or engineer, a judgment or an arbitral award, be supported by a written statement (whether in the demand itself or in a separate document or documents accompanying the demand and referred to in it) stating that the Principal/Applicant is in breach of his obligation(s) under the underlying contract(s) or, in the case of a tender guarantee, the tender conditions and the respect in which the Principal/Applicant is in breach.

**A reduction clause**
A guarantee may contain express provision for reduction of the guarantee amount.

The amount is reduced by a specified or determinable amount or amounts on a specified date or dates or upon presentation to the Guarantor of the document(s) specified for this purpose in the guarantee.

**Effective clause**
A guarantee enters into effect on the date of issuance unless the terms of the guarantee 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. Advance Payment Guarantees usually contains such a condition and do not allow for the guarantee to come into effect until the advance payment has been received by the Principal/Applicant.

**Whether or not the guarantee is transferable**

**Reference to applicable rules**
ICC Uniform Rules for Demand Guarantees (URDG458)
ICC International Standard Practices (ISP98)

**Additional points to consider before signing a contract**
- Who pays the Issuing Bank's charges/commission/fees?
- How should the guarantee be drafted?
- Which law and jurisdiction should apply?
## Glossary of terms

**Accessory Guarantee**
Is dependent on the underlying contract and the Guarantor is entitled to invoke the defences which the Principal/Applicant might have against the Beneficiary.

**Advance Payment Guarantee**
See description in Types of guarantees.

**Applicant (Principal)**
The party on whose behalf the guarantee is issued.

**Aval**
The holder of an accepted bill of exchange is guaranteed payment on the maturity date.

**Beneficiary**
The party in whose favour the guarantee is issued.

**Bill of Lading Guarantee (Steamship guarantee)**
See description in Types of guarantees.

**Borgen**
A guarantee that is linked to the underlying contract.

**Counter-Guarantee**
The Instructing party’s undertaking towards the issuing or local bank.

**Counter-Indemnity**
The Principal’s undertaking towards its bank.

**Demand Guarantee**
Payment under the guarantee must be made immediately without recourse.

**Effective date**
The date on which the guarantee is issued unless its terms expressly provide that entry into effect is to be at a later date.

**Evergreen Clause**
Gives a guarantee extendable validity (can be limited by conditions in the guarantee).

**Expiry Date**
Specific date on which the guarantee ceases to be valid.

**Expiry Event**
Specific event upon which the guarantee ceases to be valid.

**Loan Guarantee**
See description in Types of guarantees.

**Maintenance Guarantee**
See description in Types of guarantees.

**Non-Accessory Guarantee**
A guarantee independent of the underlying contract.

**Payment Guarantee**
See description in Types of guarantees.

**Performance Guarantee**
See description in Types of guarantees.

**Principal (Applicant)**
The party on whose behalf the guarantee is issued.

**Reduction clause**
A guarantee may contain express provisions concerning reduction by a specified or determinable amount, or amounts on a specified date or dates.

**Retention Guarantee**
See description in Types of guarantees.

**Standby Letter of Credit**
A non-accessory guarantee which can be used for the same purposes as a demand guarantee. Payment under the guarantee must be made immediately without recourse.

**Steamship Guarantee (Bill of Lading guarantee)**
See description in Types of guarantees.

**Tender Guarantee/Bid Guarantee**
See description in Types of guarantees.

**Unconditional**
The Guarantee contains no requirement regarding which document(s) shall support the claim.

**Validity**
The period during which the guarantee is valid.

**Warranty Guarantee**
See description in Types of guarantees.
An eye for opportunities