A COMPARISON BETWEEN GUARANTEES
STANDBY CREDITS AND
PERFORMANCE BONDS

by

Ann Johns

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ABSTRACT

This paper compares guarantees, standby credits and performance bonds as alternative methods of security. It is written from the perspective of a business person rather than a lawyer, therefore it does not purport to be a dissertation on the law of security.

With the increasing sophistication of the finance industry accountants and others need to be aware of the security alternatives available and their legal consequences.
INTRODUCTION

Many domestic inter bank and inter company loans today rely on ratings rather than security, *e.g.* a firm with a AAA rating can get credit without supplying any additional security at all.

The concept of security has become very important in major international commercial undertakings over the past twenty years. The parties to international transactions have faced increased difficulties in obtaining adequate legal protection of their contractual rights if the other party does not honour contractual obligations.

The legal instruments which are commonly used as security for these types of transactions are guarantees, standby letters of credit and performance bonds.

These instruments are all used in international transactions for similar purposes *i.e.* they have the same economic effect. However the legal forms of the three instruments are different. Also each instrument can be identified as being popular in different countries.

The objectives of this paper are to:

(i) distinguish between these instruments;

(ii) look at why this distinction is necessary;

(iii) consider the legal consequences of using these instruments.
GUARANTEES

The guarantee is a very ancient legal instrument found in all jurisdictions - (usually under the name of 'suretyship').

It may be broadly described as the strict undertaking of a party to pay a certain sum of money to another party under certain conditions in order to cover the risk of that party. (1)

In other words it is an undertaking to answer for another person's default. Thus it is a secondary obligation represented by an accessory contract. A primary contract exists between a creditor and principal debtor whereby the debtor owes the creditor an obligation (either money or service).

The accessory contract is between the guarantor and the creditor. The guarantor is only liable on the guarantee if the principal debtor defaults in payment to the creditor. (2)

In common law jurisdictions, where the law based on the Statute of Frauds applies, a contract of guarantee must be evidenced in writing if it is to be enforceable by legal action.

'A promise to answer for the debts, default or miscarriage of another person' has been held to include a contract of guarantee but not a contract of indemnity.

It is necessary to distinguish a guarantee from an indemnity which is a contract involving a primary obligation to the creditor. If A says to B, "Supply goods to C and if he does not pay you I will", there is a contract of guarantee. But if A says to B, "supply goods to C and I will see you are paid", there is a contract of indemnity (3)


It is interesting to note that in certain situations over recent years letters of comfort have become a popular alternative to guarantees. These are typically used by holding companies giving support to a subsidiary company. HC Ltd may state that it is convinced that SC Ltd will meet its required obligations promptly. (4) Normally a letter of comfort promises nothing, thus no legal obligation is created.

However parties entering into arrangements involving letters of comfort need to be aware of the letters' legal efficacy. For example some 'letters of comfort' may in fact be legally binding warranties. (5) Therefore if it is the finance director's intention that a comfort letter is not to be legally binding then the letter should have a clause such as, 'This letter does not give rise to any legal obligations on our part'. (6) A clause such as this clearly states the intention of the writer.

The advantage of comfort letters over guarantees from a commercial view is that the 'liability' can be kept off the Balance Sheet.

Contracts of guarantee are governed by the ordinary principles of contract law. Unless it is under seal, a contract of guarantee must be supported by consideration. Courts have held that consideration can be time and/or credit given to the debtor. Consideration is important from a commercial point of view because if it is found to be absent then the guarantee may become void.

The nature of a particular guarantor's liability depends on the terms of the guarantee. It is important from a lender's point of view to make sure that the terms of the guarantee suit his requirements. He is likely to want prompt payment from the guarantor in the event of the debtor's default.

(4) Allan, David E. et al op. cit, p. 15
(6) loc. cit
It may be possible to get a 'guarantor' who is willing to be jointly and severally liable with the Principal Debtor. In this case it is not a guarantee in the legal sense because a primary rather than a secondary obligation exists. The creditor can sue jointly the 'guarantor' and the Principal Debtor or either separately, in the event of default.

Delaume points out a potential problem for a lender who has a guarantee which is limited to a simple promise to pay if the borrower defaults. He suggests that lenders may have to exhaust all their remedies against the borrower before proceeding against the guarantor. (7)

Further complications arise if there is more than one guarantor in more than one country. Questions of whether the forum is stated in the guarantee contract and what is the proper law governing the guarantee become important.

It is beyond the scope of this paper to look at 'conflict of law' issues which may apply to guarantee contracts.

The function of the proper law of the guarantee is extensive. Amongst other things, it determines the validity of the guarantee e.g. whether the parties can enter into the contract and whether consideration is necessary for the contract to be enforceable. As the contract of guarantee is an accessory contract it depends on the law regulating the principal transaction to determine when the guarantor's liability arises. However proper law of the contract of guarantee is not necessarily the same as that of the primary obligation.

The guarantee discussed so far is one where liability is contingent on default of the Principal Debtor. In practice it is necessary to distinguish between this type of guarantee and 'bank guarantee'. A bank guarantee is an undertaking to pay a stated sum of money to the beneficiary, if the conditions

for payment set out in the instrument are fulfilled. (8) The bank guarantee is a form of contract which has developed for the needs of international trade. It does not fit into the accepted definition of guarantee. The obligation under this type of guarantee is independent of the transaction between the principal and the beneficiary and therefore different to the obligation of a surety for which the term 'guarantee' is used in some places. An 'on-demand' or first demand guarantee is similar to a bank guarantee.

With an 'on-demand' guarantee the debtor does not need to actually default before the creditor can demand payment from the guarantor. The liability to pay is autonomous and independent of the primary contract.

In this respect it is more like an indemnity than a guarantee.

(Further discussion of this type of instrument is covered in the section on performance bonds).

The Uniform Rules for Contract Guarantees require a written statement that the Principal Debtor has not fulfilled the obligation, before the undertaking to pay 'on-demand' has effect. (9) But the Uniform Rules rules are of limited value, because they only apply to contracts which expressly state that they are a subject to these rules.

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(9) Uniform Rules for Contract Guarantees
International Chamber of Commerce, Publication No. 325 (1978)
STANDBY LETTERS OF CREDIT

Since the mid 19th century American Banks have been prohibited from issuing guarantees. These were considered to be ultra vires i.e. outside banking activities and therefore void. Standby letters of credit were thus developed in the United States as a way of avoiding the restriction on guarantees. They are widely used by American banks, both domestically and internationally as a surety by which an independent and primary obligation of the bank is established towards the beneficiary to make payment or accept a draft on presentation of certain documents. It serves the function of a first demand guarantee.

The Standby credit acts as a surety in a commercial transaction between the bank's customer (account party) and the beneficiary in the case of non-performance (or non-payment) by the customer. (10) In contrast to guarantees, standby letters of credit create a primary obligation on the bank independent of the underlying commercial transaction. In this manner they are similar to an indemnity or a first demand guarantee.

Standby letters of credit, unlike documentary credits, are not mechanisms of payment. Despite this, the Uniform Customs and Practice for Documentary Credits, where applicable extend to standby letters of credit (11)

A standby letter of credit is a 'hybrid' because it is like a guarantee, but it is similar to a documentary credit in that payment is made on the presentation of certain documents without reference to actual facts.

Goode suggests that this is sufficient prima facie to prevent a standby credit being legally classified as a guarantee. (12) This is particularly important in the United States as many cases deal with the distinction between

(10) Horn, N., p. 282.
(11) Uniform Customs and Practice for Documentary Credits, 1983, Revision. ICC publication No. 400, Article I.
standby credits and guarantees.

Recovery under guarantee is subject to the primary obligor's non-performance 'in fact' of its guaranteed obligations. The guarantor is therefore only secondarily liable with respect to the same obligation of the primary obligor. Recovery under a standby credit requires only the presentation of the necessary documents (whether or not performance of obligations under the underlying agreement has occurred) and the issuer is primarily liable with respect to its obligations under the letter of credit.

Standby credits have also been used in Australia. Ellinger suggests several reasons for their use, particularly by merchant banks: (13)

(i) the banker does not need to be concerned with the performance of the contract between the beneficiary and the bank is entitled to be reimbursed by the account party even if the documents are forged providing the bank has accepted them in good faith;

This can be compared to business practice which regards guarantees as secondary obligations where the guarantor has to be satisfied with the validity of the beneficiary's claim before meeting his demand;

(ii) problems with guarantees as security where time or variations in contract with the account party occur;

(iii) a request for a guarantee may cast doubts on a party's credit worthiness whereas a standby letter of credit may be less obvious;

(iv) an increase in trade with the United States has led to an increase in the use of standby letters of credit.

The 1983 Revision of the Uniform Customs and Practice for Documentary Credits which brought standby credits within the definition of a documentary credit,

has some practical effect. One instance is a credit which does not specify whether it is revocable or irrevocable. Where the Uniform Customs apply, such a standby credit is deemed revocable by Article 7c unless stated irrevocable. If the same document was governed by common law, it would be considered irrevocable. (14) Other articles of the Uniform Customs which are relevant to standby credits are those defining the bank's general liabilities. i.e. Articles 15-21.

Parties to a Commercial transaction should be aware when considering using standby credit that, in reality, such an instrument leaves the account party almost entirely at the beneficiary's mercy. In view of the autonomous nature of the standby credit, the bank is obligated to accept and to pay a bill of exchange accompanied by the certificate in which the beneficiary states the account party's default. The banker is neither obligated nor entitled to investigate the truthfulness of the beneficiary's claim. When such a certificate claims a fact which to the banker's knowledge is obviously false, a court may grant an injunction precluding the issuing bank from accepting the bill. (15) Case law, however, suggests that this "fraud rule" is applicable only in 'extreme cases in which the beneficiary's claim is patently without any possible basis in fact and in which the fraud can be established without difficulty'. (16)

An account party who is asked for a standby credit should insist that the certificate of default, against which payment is to be made by the issuing bank under a standby credit, be provided by an independent third party. It may be difficult to provide for a certificate issued by an independent third party if the standby credit is issued in order to secure a loan granted by the

(14) Ellinger, P, p. 104
(15) loc, cit.
beneficiary to the account party. But it may be possible to insist that a certificate attesting default be signed by auditors or by a firm of accountants. An untruthful statement would usually confer on the account party a right of action for misrepresentation, deceit or negligence against the third party who issued the certificate. The value of such a right would depend on that third party's creditworthiness.

A standby credit can create serious problems affecting at least two parties to the transaction. Whilst the beneficiary gains a 'first class' security, the issuer of the standby credit and the account party have to consider their position very carefully. The same applies with respect to first demand guarantees and performance bonds. However Ellinger claims that as Australian merchants are more familiar with these than with standby credits, it may be advisable to stipulate either a first demand guarantee or a performance bond rather than standby credit. (17)
PERFORMANCE BONDS

Performance bonds appear to be mainly used in the United States for both domestic and international transactions, such as sales and construction contracts. The surety such as an insurance company, agrees with the customer or buyer to 'guarantee' proper performance. It could be used with a sale or construction contract in case the supplier or contractor fails to perform. Normally evidence of non performance is required.

Under English common law and international practice, the concept of a performance bond is often used in a way similar to a guarantee or an indemnity. Under English law, a bond is 'an instrument under seal', usually by deed poll, whereby one person binds himself to another for the payment of a specified sum of money either immediately or at a fixed future date. (18)

Performance bonds, either conditional or on demand are issued by British Banks in international commercial transactions. Under a conditional bond the guarantor becomes liable as a result of the principal's default (e.g. the builder or seller).

An unconditional or 'on-demand' performance bond is one in which the guarantor becomes liable when a demand is made on him by the owner. The significant feature here is that there is no necessity for the owner to prove any default by the principal in performance of the principal contract. (19)

The legal form of a bond can be used for the same purposes as a standby letter of credit. In such a case, liability under the bond can be made subject only to a statement of the beneficiary that the principal has not fulfilled his

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(19) Wood Hall Ltd v The Pipeline Authority (1979) A.L.J.R. 487
contractual duties, or even to a first demand without such a statement. In the Edward Owen Engineering Ltd Case (20) it was held that an unconditional performance bond was enforceable against the bank even though the Libyan Government (obligee) had broken a term of the principal contract.

From the sellers point of view if he is committing say 10% of the purchase price to the call of the beneficiary it is important to try and minimise his commercial risk. There are a number of ways to attempt to do this. Firstly one can try to establish the honesty (or credibility) of the beneficiary through credit checks. Another possibility is to increase the contract price to cover any call on the bond. However, this strategy may not be commercially feasible in a competitive market.

As with any other international transaction it is important to establish the choice of law and jurisdiction in case any problems arise in the future.

It is also clearly in the interest of the principal to ensure that the right to make a demand on the bond is not unconditional, but limited in some way.

If the bond is unconditional, English authority indicates that the only circumstance which justifies a bank not complying with the demand is where the claimant is found guilty of fraud. (21)

Businessmen, particularly exporters should be aware of the pitfalls of these instruments. In Australia, the exporter may be able to minimise his risk by obtaining insurance cover against an arbitrary demand by the beneficiary from the Australian Export Finance and Insurance Corporation (EFIC).

(20) Edward Owen Engineering Ltd v Barclay’s Bank International Ltd (1978) 1 QB 159.

CONCLUSION

A distinction was made between guarantees, indemnities and joint obligations, which are all common forms of security used in Australia.

Standby letters of credit, on-demand guarantees and performance bonds were identified as becoming more important with the increase in international transactions.

Except in the United States, where banks cannot issue guarantees, the choice between guarantees, standby credits and performance bonds, appears to depend largely on custom, and the familiarity of lawyers and bankers, with the alternative instruments.

There is no uniform international law on guarantees, standby letters of credit or performance bonds. The International Chamber of Commerce has formulated uniform rules for contract guarantees. One of the objectives of these rules is the protection of the principal from unjustified claims under the guarantee. This is done by imposing an obligation on the beneficiary to provide evidence of default by the principal.

However, these rules only apply if the parties agree to incorporate them into the contract of guarantee. Many foreign governments and particularly buyers with substantial bargaining power insist that the principal enters into 'first demand' sureties whereby the demand can be made without proof of default and without the necessity of any documentation. (22)

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In the face of tough international competition, businessmen are obliged to rely on the honesty of buyers and borrowers. They will continue to agree to comply with these sureties as they are aware that the majority of transactions are executed without any serious problems.

Although there appears to be no legal solution to the problem of unconditional sureties, it is in the interest of international trade that businessmen be aware of the potential problems and ways in which they might be minimised.

They should realize that the law enforces contracts that the parties have chosen to make themselves. It is important therefore that businessmen consider the likely legal consequences of the security involved in the event of default.

With international markets becoming more and more sophisticated it is apparent that further work in this area will have to be developed by international legal experts to ensure the protection of all parties involved with these types of transactions.
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