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Types of Letters of Guarantee

"Letters of credit are the lifeblood of commerce[1]" was one of the main takeaways of *RD Harbottle (Mercantile) Ltd w National Westminster Bank Ltd* [1978] and perhaps the most accurate expression to emphasize the importance of letters of credit in international trade. Setting the differences between letters of credit and letters of guarantee aside, it would be equally accurate to use Kerr J's famous words for letters of guarantee.

Due to lack of specific legislation with regards to the nature of letters of guarantee, the exact legal nature of letters of guarantee has been long debated under Turkish law. Regardless of different views in relation to the nature of letters of guarantee, a letter of guarantee may simply be defined as an instrument under which a bank undertakes to pay to the beneficiary (i.e, creditor) if the applicant (i.e, debtor) does not fulfil its obligations. This article will not delve deep into the legal debate revolving around the nature of letters of guarantee and confine itself to classifying letters of guarantee and examining -arguably- the most common letters of guarantee in practice.

I. Form of Payment Demand

One way to classify letters of guarantee is to take into account the form of payment request: (i) first demand guarantees and (ii) conditional letters of guarantee.

[1] Clive Maximilian Schmitthoff's Select Essays on International Trade Law, pg 432

A. First Demand Guarantees

First demand guarantees are letters of guarantee under which the bank simply commits to cover the amount specified under the letter, in the event the applicant does not fulfil its obligations under the contract.[2] In other words, if the bank issues a first demand guarantee, it guarantees that it will make the payment without ensuring that beneficiary in fact, is entitled to make a demand under the letter of guarantee,[3] and whether the applicant in fact, is in failure of its obligations.

This type of guarantee is therefore, most favorable to the beneficiary, as the beneficiary is not required to make any demands or claims to the applicant and is able to demand payment from the bank directly. From the banks' perspective, the bank will not be required to check whether any requirements for payment are fulfilled, simply because there are no requirements for payment.

This however, does not mean that the beneficiary is not required comply with the rules pertaining to the form of demand. ICC Uniform Rules for Demand Guarantees – URDG 758 ("**URDG 758**"), which is used extensively by the banks all over the world, states under the first sentence of its Article 15/a that "*A demand under the guarantee shall be supported by such other documents as the guarantee specifies, and in any event by a statement, by the beneficiary, indicating in what respect the applicant is in breach of its obligations under the underlying relationship [emphasis added].*[4]"

As the article suggests, despite the fact that a letter of guarantee is in the form of a first demand guarantee, the beneficiary will nevertheless be required to at least declare to the bank the basis of the breach of the underlying relationship, i.e. the contract, between the applicant and the

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[2] Vahit Doğan, "Banka Teminat Mektupları" (2011) pg 77
[3] Vahit Doğan, "Banka Teminat Mektupları" (2011) pg 78
[4] URDG 758, Article 15 (a)

beneficiary. If the beneficiary simply demands payment citing "*breach of contract*" instead of informing the bank what the breach is, at least in general terms, such as "*goods have not been delivered*"[5], the bank may reject the demand for payment (if the guarantee is issued as per URDG 758).

This simple requirement however, is only a small burden for the beneficiary taking into account the advantages of a first demand letter. Perhaps one of the most striking advantages would be the inability of the applicant to have any say in the payment. As far as first demand guarantees are concerned, the rule of thumb is: "*pay first, sue later*".[6] In other words, the applicant is not entitled to contest the demand for payment with a view to prevent payment of the guaranteed amount.

B. Conditional Guarantees

Unlike first demand guarantees, conditional guarantees entitle the beneficiary to get paid by the bank unless the beneficiary is able to fulfil the conditions provided for under the guarantee. The very definition of conditional guarantees also constitute the main difference between first demand guarantees and conditional guarantees: When conditional guarantees are concerned, the bank's obligation to make payment under the guarantee does not arise unless and until the conditions specified under the guarantee are duly submitted to the bank, unlike first demand guarantees where the bank's obligation to pay arises when the demand for payment is duly submitted to the bank.

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[5] Av. Akın Ekici, Nihayet Durukanoğlu "Türk Hukukunda ve Bankacılık Uygulamasında Teminat Mektupları (Garanti ve Kontrgarantiler)" pg 234

[6] Sabih Arkan, "Teminat Mektubu Veren Bankanın Hukuki Durumu, BATİDER, C. XVI (1992) pg 62.

Perhaps one of the most common types of conditional guarantees is the guarantees that require submission of certain documents to the bank. So far as documents are concerned, it is important to consider to what extent the banks are required to review the documents submitted as per a conditional guarantee. The banks will not be required to verify whether the content of the documents are accurate or not, as underlined under Article 6 of the URDG 758: "*Guarantors deal with documents and not with goods, services or performance which the documents may relate*".[7] Article 7 of the URDG 7 confirms what is suggested by Article 6: it is not possible to include conditions which cannot be documented: "*A guarantee should not contain a condition other than a date or the lapse of a period without specifying a document to indicate compliance with that condition. If the guarantee does not specify any such document and the fulfilment of the condition cannot be determined from the guarantor's own records or from an index specified in the guarantee, then the guarantor will deem such condition as not stated and will disregard it except for the purpose of determining whether data that may appear in a document specified in and presented under the guarantee do not conflict with data in the guarantee.*"

Therefore, it is the rule under guarantees issued as per URDG 758 that the guarantee cannot include any conditions other than a certain date or a document to evidence the fulfilment of the conditions.

II. Subject Matter of the Letter

Letters of guarantee may also be classified by their subject matter: (i) Bid Bonds, (ii) Advance Payment Guarantees and (iii) Performance Securities.

[7] URDG 758, Article 6

A. Bid Bonds

Bid bonds are simply letters of guarantee under which the bank guarantees that the bidder will fulfil certain obligations relating to the tender. Bid bonds are common in private contracts but they are more of a requirement in public procurements made under Turkish Law, simply because the Public Procurement Law numbered 4734 lists submission of a bid bond as a requirement for public procurements[8].

Whether issued as part of a public procurement or a private contract, it is a distinctive feature for these type of bonds to be of "temporary" nature, as the main rationale is to replace it with a performance security if and when the bidder is awarded the tender. Therefore, the content of a bid bond substantially refers to the tender and the bank guarantees to make a payment in cases where the bidder fails to submit a performance security despite being awarded the tender. An obvious result of this is that bid bonds cannot be cashed due to breach of contract[9], and can only be cashed if the tender-related obligations of the applicant are not fulfilled.

B. Advance Payment Guarantees

Advance payment bonds are letters of guarantee which ensure that an advance payment made to the applicant is paid back to the beneficiary. Advance payment guarantees are extensively used in construction and sales contracts if and to the extent an advance payment is made. In practice, when an advance payment is made to the contractor or the seller, the contractor or the seller would be required to repay the advance to the owner or the buyer in certain percentages, which is usually determined under the contract.

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8 Public Procurement Law numbered 4734, dated 4/1/2002

9 Av. Akın Ekici, Nihayet Durukanoğlu "Türk Hukukunda ve Bankacılık Uygulamasında Teminat Mektupları (Garanti ve Kontrgarantiler)" (2016) pg 132

Content will play a key role in determining whether a certain guarantee is an advance payment guarantee or a performance security.[10] This is especially important because an advance payment guarantee only guarantees that the advance payment is returned and does not guarantee the performance of the applicant in the underlying contract. This understanding has been long adopted by the Turkish Court of Appeals, particularly in their Assembly of Civil Chambers decision in 2000: "*there is no dispute, either in the doctrine nor in Court of Appeals practice, that while performance securities are issued to guarantee performance, advance payment guarantees are issued not to guarantee performance, but to guarantee that the monies paid as a loan will be returned*". [11]

It is quite usual for parties to stipulate that the advance payment guarantee will only become valid once the advance payment is made. The obvious result of this is that the payment obligation of the bank does not arise if the advance payment is not made. Another result which is not as obvious is that in practice, the banks may reject demands under an advance payment guarantee if the advance payment made to the applicant by the beneficiary does not quote the reference number of the advance payment so as to allow the bank establish a connection between the advance payment and the advance payment guarantee. Thus, if the validity of the advance payment guarantee is triggered by the payment of the advance payment, the beneficiary – who is also the party who is liable for making the advance payment- must include the reference number of advance payment guarantee in the payment instruction, in order to benefit from the terms of the guarantee.

[10] Vahit Doğan, "Banka Teminat Mektupları" (2011) 69

[11] Court of Appeals Assembly of Civil Chambers Decision E. 2000/11-121, K. 2000/139, T. 23.2.2000

C. Performance Securities

Performance securities are guarantees which simply guarantee proper performance. By a performance security, the applicant of the security guarantees to the beneficiary that it will comply with its performance obligations under the contract. In other words, with a performance security, the bank guarantees that unless the applicant does not complete the works in compliance with the underlying contract, the bank will pay the beneficiary for an amount up to the maximum amount stated under the performance security.[12] Performance securities may be in the form of conditional or unconditional, first demand guarantees.

It is common in practice, especially when construction contracts are concerned, that the performance security is expected to be valid until the end of the final acceptance of the whole works. When the stages of a construction contract are concerned, this means that the contractor may be required to maintain the performance security through provisional acceptance until the defects notification/warranty period. This requires contractors to submit two separate bonds: one performance security to cover the risks associated with the performance of the works *per se* and one defects liability bond in order to cover the risks associated with the defects notification/warranty period. It is frequent in practice that instead of submitting another letter of guarantee, the performance security automatically reduces by half and keeps in place until the defects notification/warranty period.

Regardless of the form of the performance security, which type of performance it guarantees is of vital importance. One common approach with regards to the content of the performance security would be to guarantee payment to the beneficiary if the applicant "*fails to fulfil any*

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[12] Av. Akın Ekici, Nihayet Durukanoğlu "Türk Hukukunda ve Bankacılık Uygulamasında Teminat Mektupları (Garanti ve Kontrgarantiler)" pg 132

obligations under the contract, in part or in whole". If this is the case, the protection provided to the beneficiary is wider as opposed to other cases where the bank guarantees payment to the beneficiary in failure of certain obligations, such as "*delivery obligations under the contract"* or "*warranty period obligations of the contractor*". Thus, due regard must be given to the content of the performance security, particularly for cashing the guarantee, in order not to cause any wrongful forfeiture of the performance security.

III. Term of the Letter

One general classification for letters of guarantee would be based on the term that is specified on the guarantee: bank letters can be issued with or without a fixed expiry date, regardless of their nature.

One important point to consider with letters of guarantee bearing an expiry date is that the demand for payment must be made until the expiry date. The banks have an examination period of 5 working days (following day of presentation) under Article 20 of the URDG 758, and they tend to use this period until the very end. If the demand is made on the last day of payment, it will be impossible for the beneficiary to submit another demand for payment if the bank rejects the demand because the first presentation was incomplete – e.g, missing the date or the basis of breach of contract. As such, it is common in practice for beneficiaries who wish to cash a guarantee to send the demand to the bank well in advance of the expiry date in order to have a second chance in sending a corrected demand to the bank.

As for letters of guarantee without expiry dates; these type of letters of guarantee continue to be valid and in effect until the work which is the subject of the letter is completed. Because closing

the risks associated with the letter is very difficult, banks usually do not prefer to issue letters of guarantee which are valid for an indefinite period of time.

IV. Conclusion

Letters of guarantee can be classified into various groups. The first group is based on which form the demand is made. For first demand guarantees, the risk on the beneficiary is as low as it can be, as the bank guarantees to make a payment if and when the beneficiary so request. As for conditional guarantees, risk is more balanced as the beneficiary will need to duly fulfil the conditions set forth in order that the bank does not reject payment.

Letters of guarantee are also classified in terms of their subject matter. While bid bonds are letters of guarantee that are issued in order to secure the risks associated with the applicant's failure in the its obligations relating to the tender, advance payment bonds are issued in order to secure the risks associated with the applicant's failure to fulfil its obligations with regards to the repayment of advance payment. Performance securities -hence the name- are issued to cover the general risks associated with the applicant's performance, although they can be limited in terms of content. Regardless of the form of demand required or the subject matter, letters of guarantee may be classified into different groups in terms of their expiry date.

It is beyond doubt that there are many other classifications and forms of letters of guarantee which are not included in this article. Regardless of the different types, form and practice around letters of guarantee, they have one common goal: to secure the risk.

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