

SITPRO

International Trade Guides

Financial

Demand Guarantees



Demand Guarantees

This guide explains what a Demand Guarantee is and using simple easy to follow flow charts tells you what types are available and how they work. The guide also highlights some of the pitfalls to watch out for when using Demand Guarantees.

You should read it if you have been asked to provide a Demand Guarantee by your overseas customer. You may wish to pass on the information in this Briefing to your colleagues in the Sales & Marketing team so they are prepared should the issue of Demand Guarantees be raised during contract negotiations with potential customers.

If your company already uses Demand Guarantees in its overseas business you may still find this guide useful as an easy to use reference document or checklist of current best trading practices.

You may also wish to read the SITPRO Report on the use of Demand Guarantees in the UK (2003), which gives a greater insight into this payment security method with analysis of a survey, conclusions and recommendations.

Introduction

An importer who wishes to have security that an exporter will perform its obligations can ask the exporter to provide a Demand Guarantee. This would be a written undertaking by a guarantor, usually a bank, to pay the importer up to the maximum sum quoted on the demand guarantee upon presentation of a demand together with any other documents specified under the terms of the bank's guarantee. The exporter undertakes to repay the bank.

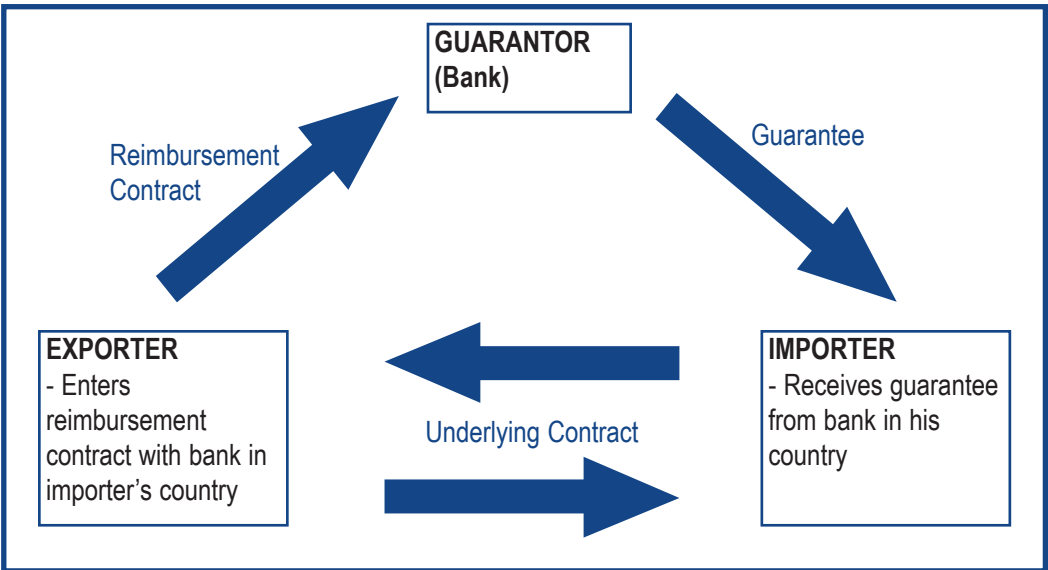
Demand Guarantees are like substitutes for cash and must be honoured on presentation of a written demand that complies with the provisions of the Demand Guarantee. They have a number of uses and are frequently required, for example, in construction project contracts and for doing business in countries throughout the Middle East, but can also be found in other business sectors as well, even replacing rent deposits in leases on homes. Whereas a Letter of Credit (also known as a "Documentary Credit") would provide security for the exporter against non-payment, a Demand Guarantee provides protection to the importer against non-performance, or late or defective performance, by the exporter or contractor. Many demand guarantees are payable on first demand without any additional documents, which reflects their origin in replacing cash deposits, although increasingly guarantees require at least a statement indicating that the exporter is in breach.

Different Types of Demand Guarantees

There are two basic ways of issuing a demand guarantee:

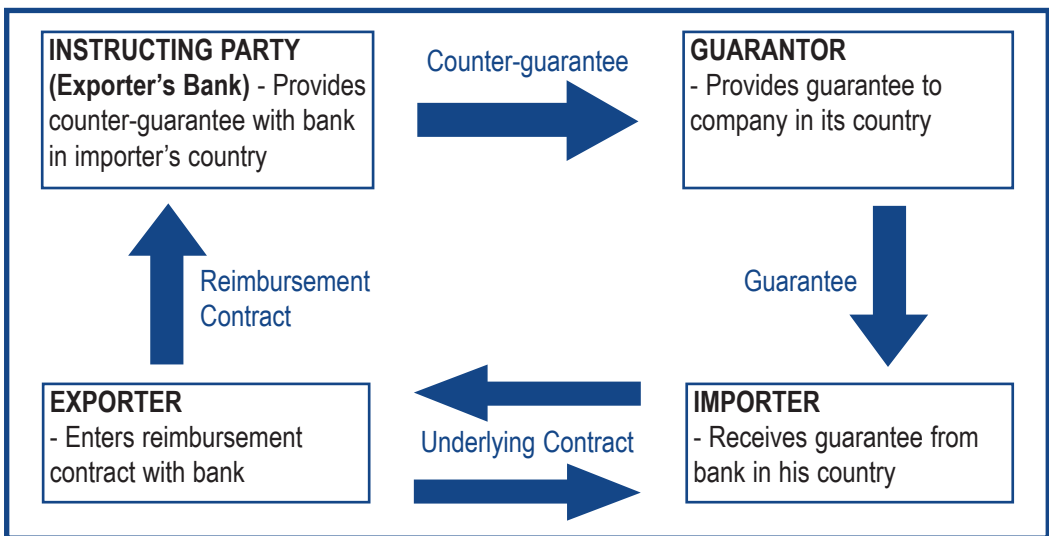
Direct Guarantee

A Direct Guarantee is provided by the exporter's bank directly to the importer with the exporter giving its bank sufficient funds, or an indemnity, or other form of security, against the cost of meeting claims. In this scenario there are three distinct contracts: the underlying contract between the exporter and the importer, the counter-indemnity (re-impbursement contract) between the exporter and its bank and the guarantee between the exporter's bank and the importer.



Indirect Guarantee.

An Indirect Guarantee is provided by the importer's own bank. The exporter's bank will provide a counter-guarantee to the local bank with the exporter providing sufficient funds, or an indemnity, or other form of security, to its bank (as in a direct guarantee) against the cost of meeting claims. Here there are four distinct contracts: the underlying contract between the exporter and the importer, the reimbursement contract between the exporter and its bank, the counter-guarantee between the exporter's bank and the bank in the importer's country and the guarantee between the importer's bank and the importer.



Main Uses of Demand Guarantees

Demand guarantees are used in a number of different contexts. The main ones are:

- **Tender or Bid Guarantee:** This is to safeguard the party inviting the tenders against the withdrawal of a tender after the tender closing date from or the non-signing of the resulting contract by the successful tenderer. It is also provided to safeguard against the successful tenderer signing the contract, but not providing the agreed performance guarantee.
- **Performance Guarantee:** A performance guarantee is to safeguard the importer against the consequences of non-performance of the contract by the exporter.
- **Advance Payment Guarantee:** An advance payment guarantee is to safeguard the importer against giving an advance payment and the exporter subsequently failing to perform the contract.
- **Retention Guarantee:** A retention guarantee safeguards the importer against the early release of retention monies (required as a form of warranty security), as opposed to stage payments, and the exporter failing to perform what remains of the guarantee.
- **Warranty Guarantee:** A warranty guarantee safeguards the importer against the non-performance of the warranty by the exporter.

A fundamental feature of Demand Guarantees under English law is that the guarantee is completely separate from the underlying contract (i.e. the contract for sale of goods or services) between the importer and the exporter. This feature is incorporated into the Uniform Rules for Demand Guarantees (URDG) published by the International Chamber of Commerce - see [ICC rules](#) below. Additionally the guarantee given by the bank to the importer is separate from the counter-indemnity given by the exporter to its own bank and also from any counter-guarantee given by the exporter's bank to the importer's bank in an indirect guarantee.

This means that if a demand is made by the importer, accompanied by any additional documents called for under the guarantee, payment must be made, regardless of whether or not the exporter has failed in any of its contractual obligations.

Problems Arising from the use of Demand Guarantees & Solutions

Cash Flow Problems

For any company, providing a Demand Guarantee may well have an affect on its cash flow or banking facilities. This is especially problematic for smaller companies who do not have the cash flow to cope with a sum of money being tied up indefinitely. There is no magical cure to this, but we would suggest:

- When the contract is first being negotiated, question the need for a guarantee.
- If insistent upon a guarantee, ask the customer to reduce the sum involved or ask for a reduction of amount clause.
- Negotiate the wording of the guarantee with your customer and ensure it includes an expiry date and a provision for it to be returned to the bank on expiry - your bank should be able to help you with this.

Unfair Calling

One of the inherent risks of a guarantee payable on demand is that it may be called in "unfairly" when the conditions of the contract have been met. It is worth remembering that, although it can be a difficult experience for anyone affected by unfair calling, it is not a common occurrence in practice. However, you should consider the following points:

- Obtain insurance against "unfair" calling of the guarantee. (Insurance can also be obtained against "fair" calling of the guarantee where the contract could not be performed for "political reasons", e.g. non-renewal of import/export licences, the imposition of embargoes or the inability to complete a contract due to war or civil unrest).
- Try to ensure that the terms of the guarantee provide a clear mechanism for making claims (e.g. URDG).
- If a guarantee is called which you consider to be "unfair", negotiate with your customer if you have the chance.

Expiry Date

Some countries, particularly in the Middle East, may not accept a Demand Guarantee which includes an expiry date as this may not be enforceable in law. Therefore the local bank guarantor may not be prepared to cancel the liability, after expiry, without the beneficiary's agreement. This can cause problems, especially an open-ended balance sheet liability.

- In certain countries it has been possible to overcome resistance to expiry dates in Demand Guarantees by using a Standby Letter of Credit which will include an expiry date if it is made subject to ISP98 (Articles 47-49). The URDG contain a set of expiry provisions as well

(Articles 21 through 25) - see [ICC Rules](#) below.

- Some exporters may receive "extend or pay" demands, issued by their importer for a variety of different reasons. This could be to bring about delivery of the agreed work in the case of a breach of contract. It could also be used in cases where there is concern the exporter may file for bankruptcy and cease to carry out the remainder of its contract. In many cases this can be resolved by negotiation; if not, extending is usually preferable to paying.

ICC Rules

ICC's Uniform Rules for Demand Guarantees were published in 1992 and are designed to be in accordance with established bank guarantee practice, where most demand guarantees are payable on first written demand.

SITPRO's report on the Use of Demand Guarantees in the UK (July 2003) found that very few demand guarantees are in fact issued subject to URDG. It is strongly recommended that exporters consider these rules and incorporate them into Demand Guarantees wherever possible, as they reflect international practice, balance the interests of the different parties involved and aim to reduce the incidence of "unfair calling".

It is worth noting that Standby Letters of Credit can fulfil the same purpose as a Demand Guarantee. For further information, see SITPRO's guide - [Letters of Credit: An Introduction](#).

Where can I get further information?

- ICC (UK) Tel: 020 7838 9363.
- ICC Uniform Rules for Demand Guarantees - ICC Publication No. 458
- ICC International Stand-By Practices (ISP 98) - ICC Publication No: 590
- A User's Handbook to the URDG - ICC Publication No: 631
- Guide to the Uniform Rules for Demand Guarantees - ICC Publication No: 510
- SITPRO Report on the use of Demand Guarantees in the UK (2003)

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