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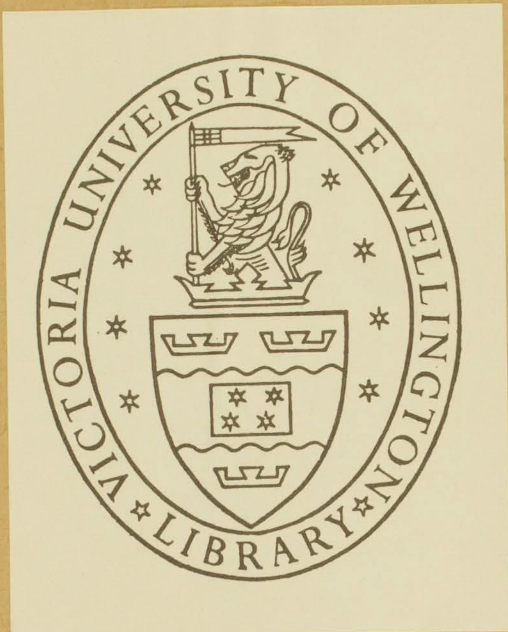
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BANK GUARANTEES AND INTERNATIONAL TRADE

Research paper submitted for the
Degree of Bachelor of Laws with
Honours in Law at the
Victoria University of Wellington.

1976

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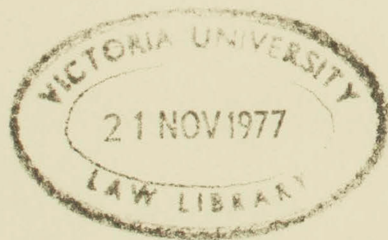
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1. Introduction

The aim of this paper is to examine the role which bank guarantees play in international trade, concentrating on the area of "contract guarantees" being those issued by a bank.[1] At the moment there are no specific rules governing bank guarantees, but the I.C.C. has formulated a set of Revised Draft Uniform Rules governing entry into bank guarantees, indemnities or similar undertakings.[2] This paper will cover the effect of RDUR on bank guarantees, and an analysis of the possible legal implications which would arise under bank guarantees.

2. What is a Bank Guarantee?

In essence, a bank guarantee is a guarantee given by a bank (surety) to an individual or firm (beneficiary) at the request of the customer (principal), generally for overseas transactions as opposed to a guarantee given to a bank by an individual or firm.[3]

3. What is a Guarantee?

In Mountstephen v. Lakeman[3a] Willes J. stated -

> "A guarantee is essentially a contract of an accessory nature, being always ancillary and subsidiary to some other contract or liability on which it is founded and without the support of which it must fail."

This definition was affirmed by sub nom see also Morin v. Hammond[3b]; Lakeman v. Mountstephen[3c]. Furthermore, the

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1. The writer does not propose to cover "payment guarantee" furnished by the buyer in this paper.
2. See Art. 1 RDUR.
3. It is to be noted that bank guarantee does not necessarily be given only by a trading bank. It could be issued by merchant bank or similar type of financial institutions.

3a. (1871) L.R. 7 Q.B. 196, Ex.Ch. at p.202.

3b. [1923] S.C.R.140; [1923] 1 D.L.R. 519.

3c. (1874) L.R. 7 H.L. 17 at pp. 24, 25 per Lord Selborne.

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promisor in the guarantee undertakes to be answerable to the promisee for debt, default, or miscarriage of another person, having an existing or contemplated primary liability to the promisee. The contract may be constituted by a personal engagement on the part of the surety, or by a charge on property without any personal liability, or by both - Smith v. Wood[3d]; Re Conley[3e]. In the case of the bank guarantee, the bank (surety) will become liable to the beneficiary upon the default of the principal.

4. Parties to the guarantee

In Duncan Fox & Co. v. North & South Wales Bank[3f] it was pointed out by Lord Selborne that three possible variations exist regarding the parties to a contract of suretyship.

(1) Where all three parties concerned are parties to the guarantee, in the sense that both the principal debtor and creditor agree that that surety's liability is a secondary liability only. The principal debtor is primarily liable for the obligations guaranteed.[4]

(2) Contract of suretyship may be recognised only as between the principal debtor and the surety; or

(3) as between the creditor and the surety.

In the case of bank guarantee, the mere fact that the guarantee is given by a bank will not change its basic nature as a guarantee.

The prima face differences between bank guarantee and other guarantees are that -

(a) the terminology in the former involves principal, surety and beneficiary as opposed to principal debtor,

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3d. [1929] 1 Ch. 14.

3e. [1938] 2 All E.R. 127.

3f. (1880) 6 App. Cas. 1 at pp. 11-12.

4. Bank guarantees fall within this category.

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surety and creditor respectively;[5]

(b) an intermediary bank is involved in bank guarantee a factor which is not present in the case of other guarantees.

In a three party bank guarantee, the parties involved are namely the bank, principal (customer of bank) and the beneficiary. The promisor is the bank and the promisee is the beneficiary. With reference to a four party bank guarantee, the parties are the bank, intermediary bank, principal and the beneficiary. The promisor could be the intermediary bank, depending on whether it assumes an advisor or confirming role. The promisee remains the beneficiary.

(c) Bank guarantees are used in international trade which is not so with other guarantees.

(d) Bank guarantees will be governed by RDUR presuming the RDUR is formally adopted.

This paper is concerned with bank guarantees and international trade. The latter is defined as trade among countries across national boarders using foreign currencies.

Prof. Ernst Von Caemmerer in his paper on Bank Suretyships and Bank Guarantees in Foreign Trade said:

> "Bank Suretyships and bank guarantees play an important role in foreign trade and at the same time, suretyship transactions are an important part of the business of European banks. If one asks the question which transactions the banks in Europe use for payment and payment ~~securety~~ security in foreign trade, letters of credit and bank guarantees stand in the foreground." 5a

In this paper, guarantee is used synonamously with securetyship.

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5. See terminology in I.C.C. RDUR.

5a. For a definition and distinction of guarantee and suretyship see Campbell v. McIsaac (1873(9 N.S.R. 287 (C.A.); Foster v. Ivey (1901) 20 L.R. 480.

5. What is an indemnity?

The term indemnity is frequently used to denote a contract by which the promisor undertakes an original and independent obligation to indemnify, (usually upon a contingency) as distinct from a collateral contract in the nature of a guarantee by which the promisor undertakes to answer for the default of another person who is to be primarily liable to the promisee.[6]

In the strictest sense an indemnity denotes a contract to render the promisee free from liability resulting from claims of third parties, whether the obligation to meet those claims arises out of some contractual duty of the party indemnified or otherwise.[7] When used in this sense, it will not comprise a contract of marine insurance against the loss of or damage to the subject matter of the insurance - Johnston v. The Salvage Association.[7a] Indemnity in the strictest sense will not cover insurance which have for their object the protection of the assured against liability to third parties. Re Law Guarantee Trust & Accident Society Ltd., Liverpool Mortgage Insurance Co.'s case.[7b]

6. Distinction between guarantee and Indemnity

In Guild & Co. v. Conrad[7c] the defendant orally promised the plaintiff that, if he, the plaintiff would accept certain bills for a firm in which the defendant's son was a partner, he the defendant would provide the plaintiff with funds to meet the bill.

It was held by the Court of Appeal, consisting of Lindley, Lopes and Davey LJJ that this was a promise of indemnity and not of guarantee. Following from this decision,

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6. Mountstephen v. Lakeman (supra)

7. The Indian Contract Act 1872 (No. IX of 1872) s.124 provides that an indemnity is "a contract by which one party promises to save the other from loss caused to him by the conduct of the promisor himself, or by the conduct of any other person."

7a. A contract of marine insurance is an indemnity contract. (1887), 19 Q.B.D. 458 C.A.

7b. [1914] 2 Ch. 617 C.A.
7c. [1894] 2 Q.B. 885.

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a contract of indemnity renders the party primarily liable; this is the distinguishing feature between it and a contract of guarantee.[7d] In S.2 - Contracts Enforcement Act 1956, the definition of guarantee requires that the surety should be answerable for the debt, default or liability of another. The surety is only secondarily liable: there must be some contract or obligation existing between the principal debtor and the creditor, and it is only when the principal debtor, who is the person primarily liable, fails to pay what is due or otherwise perform his obligation, that the liability on the part of the surety arises either alone or jointly with the principal debtor. This distinction is reinforced by Lord Selborne in Lakeman v. Mountstephen (1875) L.R. 7 H.L.17 at p.24:

> "There can be no suretyship unless there be a principal debtor, who of course may be constituted in the course of the transaction by matters ex post facto, and need not be so at the time; but until there is a principal debtor there can be no suretyship. Nor can a man guarantee anybody else's debt unless there is a debt of some other person to be guaranteed."

However, in view of the fact that the RDUR applies equally to bank guarantees and indemnities, it is therefore in practice not necessary to distinguish between guarantee and indemnity.

7. Why is the distinction important in other guarantees?

(1) The distinction is important as illustrated by Coutt & Co. v. Browne Lecky [1947] K.B. 104. The issue in this case was whether the surety was liable where the main contract was void owing to the principal debtor's incapacity. The answer to this issue was dependent on the distinction between guarantee and indemnity.

Oliver J. held that the surety was not liable because there was no default by the infant in not meeting the liability, and the surety could not be called upon to meet his liability unless there is such default. His Honour applied the House

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7d. See McDougall v. Gariepy [1922] 1 W.W.R. 422.

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of Lords decision in Swan v. Bank of Scotland.[7e] If, however, the contract was an indemnity then the surety would assume a primary liability to indemnify the creditor in any event, the infancy of the debtor providing no defence to the surety.

Yeoman Credit Ltd. v. Latter [1961] 1 W.L.R. 828. This distinction also applies to other invalidating causes.

(2) The liability of the guarantor is normally co-extensive with the liability of the principal debtor, so that if the debtor is discharged the surety will also be discharged, whereas if the contract is one of indemnity, the surety is not necessarily discharged.[8]

8. Statute of Fraud

In New Zealand, s.2(6) of the Contracts Enforcement Act 1956 expressly provides that s.2 of the Act replaces s.4 of the Statute of Frauds 1677, that section thus ceasing to have effect in New Zealand, except in respect of contracts made before the passing of this Act. Basically both s.4 of the Statute of Frauds 1677 and s.2(2) of the Contracts Enforcement Act 1956 require that the contract be in writing, and signed by the party to be charged therewith, or some other person having received lawful authorisation from him. By virtue of s.2(d) guarantee contracts are within the Act.

The only difference between s.4 of the former Act and s.2 of the latter, is that in the English Act the words "miscarriage of another person" are used instead of the phrase "liability of a third person". It is submitted that this difference is not material.

9. What significance do "debt, default or liability of a third person" have on guarantee/indemnity?

Birkmyr v. Darnell (1704) 1 Salk 27 supported the view

7e. 10 Bligh N.S. 621.

8. See para. 1681 - 1699 Chitty on Contracts 2 ed.

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that s.4 of the Statute of Frauds Act 1677 only applies where someone other than the surety is primarily liable. In essence, guarantee is within the section whilst indemnity is not.

10. Classification of bank guarantees

There are four types of guarantees that are issued by the banks in relation to international trade, they are:

(a) tender guarantee
(b) performance guarantee
(c) custom guarantee
(d) repayment guarantee.

(a) Tender guarantee

In the field of international trade, if an exporter or manufacturing company desires to participate in foreign competitive bidding, he must furnish a bank guarantee of a particular amount in support of that bid.

The bank at the request of the exporter (tenderor) will issue a bank guarantee to the buyer (tenderee). The bank guarantee serves as an assurance or a kind of security that the firm (exporter) will not withdraw its offer if he is successful in his bid.

Hence this gives protection to the tenderee (beneficiary) against damages which he would suffer through the withdrawal of the offer. The reason being that the moment the tenderee accepts the tenderor's tender, the unsuccessful tenders would lapse immediately - see Art 6.

In general, tender guarantees provide for 5-10% of the value of the contract price.

(b) Performance guarantee[9]

The buyer, in order to ensure that the seller or contractor would fulfill his obligations in accordance with

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9. See Farmer v. The Chairman, Councillors (1894) 13 NZLR 311.

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the contract, would require the seller/contractor to furnish him a performance guarantee. This would protect him against delay, defective delivery or unsatisfactory performance.

A performance guarantee could arise in a sale situation or in a building contract.

In the former situation, if the buyer places an order for goods which are required for a particular purpose (e.g. Christmas decorations for Christmas), these goods would be useful to the buyer if they arrive before Christmas but not after. A performance guarantee will prevent the seller from breaching his contract where the goods are no longer required.

In the building contract situation, if it is for the erecting of a building the buyer must protect himself from a situation where a building contract is abandoned when it is only partly performed, thus requiring the engagement of yet another contractor to complete the work. A performance guarantee provides such protection. Similarly in a contract for the making of a special machine, an incomplete or defective piece of machinery is of no use to the buyer, hence the performance guarantee is used to protect the buyer from any breach of the contract. Normally the performance bond will provide a specific sum for damages in case of a breach of contract. A performance bond is also an indemnity - <u>Dawson & Hall Ltd. v. U.S. Fidelity and Guarantee Co.</u>[9a]

(c) <u>Custom guarantee</u>

A custom guarantee is furnished by the bank on behalf of the importer to the Customs Department for the postponement of the payment of import duty.

(d) <u>Repayment guarantee</u>

The seller/contractor will furnish a repayment guarantee to the buyer. For example in a contract for the building of a plant, or other building contracts, the buyer is required to

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9a. (1963) 38 D.L.R. (2d) p.53 at p.56 per Davey J.A.

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either make progressive payment in relation to work done by the contractor or make a lump sum advance payment to the contractor. In either case, if the contractor does not complete the work corresponding to the amount paid, the buyer will be able to protect himself by a repayment guarantee by obtaining a refund of the money paid in advance.

11. Bank guarantees as credit transactions

There is a distinction between effective provision of credit and provision of credit through simple assumption of liability (i.e. the bank only lends its name).

Effective provision of credit exists when a credit sum is placed at ones disposal such as a loan, or when claims are postponed. The provision of credit also includes the delivery of goods with postponement of payment. This is referred to as commercial credit. The recipient of credit is given effective purchasing power.for a period of time. After the expiration of the credit term he must repay to the bank any loan made.

In the case of provision of credit through simple assumption of liability, the bank does not lend money to the customer but rather extends to its customers its credit, in the sense of creditworthiness - i.e. the credit which it enjoys. The customer, by relying on the creditworthiness of the bank, is then able to obtain effective credit in the form of commercial credit, instalment credit, custom postponement etc. This is possible when the bank acts as surety (thereby assuming contingent liability) for the customer. The creditability of the bank is usually accepted by the business community much more readily than an individual or firm.

The most important cases of provision of credit by assumption of liability are (a) acceptance credit and (b) surety credit, as illustrated by, for example, custom guarantee.[9b]

9b. The above does not apply to tender or performance guarantees.

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Surety credit

This could be explained by reference to postponement of the duty to pay on the basis of the custom guarantee. The government custom office is often prepared to postpone the payment of import duty by the importer on the imported goods. This in actual fact provides the importer with effective credit. During this time, the importer is able to raise finance on the basis of the bank's credit. In the event of the importer's default, the bank would assume the liabilities on his behalf.

In practice, it is not feasible (in terms of administrative cost) for the custom officials to check on the creditability of importers, or to analyse closely the security for this provision of credit against the conveyance of the merchandise, or the assignment of the accounts receivable. Hence the bank could play a useful role in terms of the Customs Department as it is in a better position to check on the creditworthiness of the importer as well as the value of the security advanced by the importer. Furthermore, the banker who issues a custom guarantee is protected by a counter guarantee or indemnity, and also other securities e.g. by way of chattel, mortgage of company's assets or floating charge. Further protection for the banker arises from the special expertise available to the bank in dealing with securities. Hence the banks provide the most ideal vehicle to bridge the gap of creditworthiness and confidence between the importer and custom department at no extra administrative cost to the other parties.

The bank by issuing the custom guarantee has assumed the following functions:

(1) essentially helps to ease the conflicting financial interest between the custom department and the importer;

(2) reduces the unnecessary administrative cost in employing experts to check on the value of securities and also to determine the creditworthiness of the importer;

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(3) from the point of view of the importer, the most beneficial aspect of the arrangement is that the custom guarantee provides him with effective credit as a result of the postponement of his duty to pay the amount due to the custom department. Thus this is of utmost importance to private firms as such money may therefore be channelled to meet more pressing needs, for example the payment of a bill for a piece of capital equipment, with better machinery and modern technology this will result in a higher output.

12. An analysis of specimen copies of tender guarantees in relation to RDUR

Art I of the RDUR (issued by the I.C.C.) applies to all guarantees, bonds, indemnities or similar undertaking. The title of the Rules expressly provides for Tender Performance and Repayment Guarantees (contract guarantee), it may be questioned whether the Rules cover custom guarantee. The phrase 'however named or described' would suggest that custom guarantee should be included.

Tender guarantee is defined by Art 2(a) as an undertaking by the bank (surety) to answer for the default of the tenderer. The guarantee is issued at the request of the tenderor (the principal) to the tenderee (beneficiary). This point could be illustrated by "On instruction of X Ltd. for their participating in the tender, the bank hereby guarantee ...". No. (1).

Art. 3 deals with the problem of currency. In the case of a tender guarantee, it is to be the currency and the amount stated in the invitation to tender. This Art. could be invoked in the absence of any stated currency in the guarantee.

In order to succeed under Art. 2(a) by a beneficiary, two conditions must be fulfilled:

(1) the principal must be successful in his bid;

(2) he must have withdrawn from the tender.

No. (1) is very clear on this point as the guarantee

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provides "... bidder has been accepted but the said company refrains from signing contract within specific period ...".

No. (2) "... for the due fulfillment of their obligations object of this guarantee in case their tender is accepted ...".

No. (3) "... guarantee payment due to you by tenderor on their failure to abide by their tender/quotation on and for subsequent withdrawal of the said tender/quotation."

No. (4) is not explicit on this point as illustrated by the phrase "... to be paid ... for which payment to be well and truly made."

Art. 5 provides a guarantee should have an expiry date. Where no expiry date is stated in the tender guarantee, it shall be deemed to expire six months after the date of issue. In No. (1), the tender guarantee is valid for three months from the tender closing date. Nos. (2) and (3) do have a fixed or determinable date regulating the validity of the guarantee, but makes no reference to the closing date of the tender.

No. (4) does not seem to comply with Art. 5, it includes no reference to an expiry date.[10] In the absence of RDUR the beneficiary has longer protection from the guarantee than would be the case with the Rules in operation. Is six months after the date of issue an adequate period? In view of the different types of tender contracts, this may be doubted.

Tender Guarantees

Dunton v. Wannambol Waterworks Trust[11]

Dunton tendered to carry out certain work for W, under specific conditions of tendering, enclosing with his tender a cheque for £200, in accordance with the terms of the advertisement calling for tenders. W was a Waterworks Trust under the Water Act 1890. It cannot act without first

10. This is not an unusual practice. Although the issuing banker is not happy about it but there is very little that they can do if the beneficiary insist on having a guarantee without any expiry date.

11. (1893) 19 V.L.R. 84.

obtaining the approval of the Governor in Council. Condition 8 indicated certain successive steps which must be taken by the contractor: it was his duty to do certain things, and until these requirements were satisfied, there was no duty cast upon W to do anything if the contractor failed to do any of these things under condition 8, then his deposit may be forfeited as liquidated damages.

Condition 11 was provided with the intention that nothing done inadvertently by W should be held to raise any obligation on them (by implication) or bind them in any way.

D's tender was accepted. He paid the balance of 5 % over and above the amount of his preliminary deposit, but did not execute the contract deed. Later he desired to amend the tender but such alteration was refused. He then asked for the return of his deposit refusing to go ahead with the tender.

The full Court (Madden C.J., William and A'Beckett JJ) found for W, on the basis of existence of specific conditions of tendering, whereby W was entitled to forfeit the deposit and therefore tenderer (D) could not recover.[11a]

Another example of a dispute regarding tender guarantee is Stafford v. Mayor Councillors and Citizens of South Melbourne.[12]

A municipal council advertised for tenders for certain work, and invited inspection of the specifications. The plaintiff submitted a tender in which he stated "I herewith make a preliminary deposit of ₤50 ... such sum to be absolutely forfeited to the council as liquidated damages and not by way of penalty in the event of withdrawing, cancelling or rescinding this tender or failing to enter into a properly

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11a. The Chief Justice's reasoning was influenced to a great extent as W was created by an Act and derived its power from the Act (i.e. under the control of the Governor General) see p. 94,95 of case. This decision could be avoided if the tenderee (beneficiary) is not a creation of a statute.

12. (1908) V.L.R. 584.

executed contract for the performance of the work ... after being called upon so to do."

The plaintiff deposited £50 with the tender accordingly. Before the tender was accepted the plaintiff withdrew it. In a suit against this action of the tenderer laid against the municipality to recover the £50 the Full Court (A'Beckett, Hodd and Cussen JJ) held that there was a binding contract under which the Council was entitled to retain the £50 in the event of the tenderer's withdrawal of his tender before acceptance. The promise of the council to consider the tender was a sufficient consideration to support the contract notwithstanding s.456 of the Local Government Act 1903 (Vic). The burden of proving that the contract was not made in the manner prescribed by s.455 of that Act was upon the plaintiff.[13]

13. Types of claim under a tender guarantee

No. (1) the claim is expressed in terms of 'merely upon your advice'.

No. (2) 'upon your first demand notwithstanding any contestation'.

No. (3) 'on demand'.

Art 7 - a claim under a guarantee subject to RDUR shall not be honoured unless it satisfies the requirements of either Art 8 or Art 8 bis (as the case may be) and is lodged with the guarantor in writing, by cable, telegram or telex not later than the expiry date.

Art 8 refers to a claim where documentations must be produced in order to support a claim.

Art 8 bis deals with a guarantee payable on simple or first demand, or does not specify the documentation to be produced in support of a claim. Nevertheless a claim under Art 8 bis in relation to tender guarantee must be accompanied by a statement of default of the tenderor by the tenderee (beneficiary).

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13. This decision may be decided differently in the light of Art 2(a) RDUR or in view of the wording of No. (1).

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A simple or first demand guarantee in terms of Art 8 bis becomes effective upon the receipt of the statement of default by the guarantor; he must make payment immediately on expiry of a period of seven working days from the date of receipt of the claim.

Art 7 provides that on receipt of a claim, the guarantor shall immediately fall under a duty to notify the principal of the claim and of the supporting evidence received.

14. What are the rights of the surety, principal and beneficiary in the case of a first demand guarantee?

In actual banking practice, the surety has to pay to the beneficiary upon his first demand. Any dispute between the principal and beneficiary does not prevent the surety from paying to the beneficiary the required amount.[14] The surety would not even direct the beneficiary to the principal for payment. In the case of other guarantees not being bank guarantees, the surety may, after the guaranteed debt has become due, and before he has been asked to pay it, require the creditor to call upon the principal debtor to pay off the debt. This is supported by Smith L.J. at p.75 of his judgment in Rouse v. Bradford Banking Co.[14a] where the learned judge said:

> "... that a surety is entitled at any time to require the creditor to call upon the principal debtor to pay off the debt ..." 15

Similarly in Nisbet v. Smith (1789) 2 Bro. C.C. 579,582 the Lord Chancellor says:

> "It is clear and never has been disputed that a surety, generally speaking may come into this court, and apply for the purpose of compelling the principal debtor for who he is surety to pay the money, and deliver him from theobligation." 15

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14. This is confirmed by bankers dealing with first demand bank guarantees.

14a. [1894] 2 Ch. 32, C.A.

15. The existence of this right has been questioned - Ewart v. Latty (1865) 4 Macq. 983 H.L. at p.989 per Lord Westbury L.C.

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In the event that the claim by the beneficiary is unfounded, the principal can sue the beneficiary for the return of any money paid. This is admittedly a troublesome means of recovering the money, as the principal will usually have to sue the beneficiary in a foreign country. Thus the principal has no right to stop the surety from paying the beneficiary. Therefore a first demand guarantee is often an effective substitute for cash.[15a] From the beneficiary's viewpoint, a first demand guarantee is an excellent security and it gives adequate protection to him. But from the point of view of the principal it is not so favourable. Looking at bank guarantees objectively, a first demand guarantee should favour the beneficiary, otherwise it defeats the whole purpose of providing a first demand guarantee.[15b]

In relation to No. (2) 'first demand notwithstanding any contestation', this is an excellent guarantee in favour of the beneficiary. A guarantee like No. (3) 'on demand' could not be interpreted as simple or first demand as (1) the guarantee also refers to payment upon a certain document and (2) it is not expressly provided.

By leaving the claim in such vague language as 'on demand' in No. (3), it is opened to two interpretations:

(a) Art 8 could apply as documents are needed to support a claim. Payment is made by the guarantor until the expiry of a period of seven working days from the date of receipt of such claim and documentation. An important point for the guarantor to bear in mind is the need to ascertain that the documents appear on their face at least to adhere with the requirement of the guarantee.[16]

(b) The remaining alternative is that 'on demand' guarantees could fall within Art 8 bis. It provides that in all other

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15a. The above statement presupposes that banks do not generally go bankrupt.

15b. For fraud problems see p.46

16. Liability of the surety in relation to collection of documents will be discussed later.

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cases unless the principal shall authorise earlier payment and subject to other stipulations, payment is made by the guarantor immediately upon the expiry of thirty calendar days from the date of receipt (accompanied by the statement of default) by the guarantor.

15. Right of the principal in a 'demand' guarantee

Art 8 bis - If within 30 calendar days, the principal informs the guarantor that he is referring the matter to a court of law or arbitration as provided in the contract, the guarantor is not permitted to make payment until three months has expired from the date of receipt of the claim and statement. If during the three months period, there are evidences shown by the principal that the matter is to be handled by the court or referred to arbitration, no payment by surety to beneficiary is allowed until the guarantor is notified of the decision of the court. The guarantor is entitled to pay at the end of three months if he is not informed that the principal is referring the matter to court or arbitration.

In brief, the rights of the principal in the case of a 'demand' guarantee are as follows:

(1) Payment could be made via surety to beneficiary after thirty calendar days from date of receipt of claim by guarantor.

(2) Deferment of payment by guarantor until three months later if principal decides to bring the matter to Court or arbitration.

(3) Upon proof that matter is to be handled by Court or arbitration, payment would be deferred until guarantor is informed of the Court's or arbitration decision.

From the above, it could be seen that the rights of the principal in relation to deferring payment are very extensive in a 'pay on demand' guarantee. In the first demand guarantee the principal has no right to halt payment at all.

In the case of No. (1) 'merely upon your advice' is quite similar to 'upon demand'. In the absence of express provision of simple or first demand, claims expressed in other ways would not be construed as simple or first demand guarantees.

Art. 6

This is an important Art. in relation to tender guarantee as it gives the utmost protection to the guarantor in the following way. If the tender is awarded to a successful tenderor, the other tender guarantees submitted by other tenderors shall immediately cease to have effect. This is so, irrespective of the expiry date and the document containing the guarantee is required to be returned by the beneficiary to the guarantor without delay.

No. (1) does not make any stipulation similar to Art. 6; No. (2) is very clear and precise on this point. It provides that "In case our client's tender is not accepted, the present guarantee is immediately cancelled and must be returned to us". (3) has not made any provision similar to Art 6. Instead it has inserted the following "This letter of Guarantee is to be returned to the Bank for due cancellation on expiry of the validity date." It is submitted that this is just an extra step, perhaps to enhance business efficacy, but does not serve to provide any additional protection to the guarantor as does Art 6.

In No. (4) clause (2), it provides that "If the tender shall not have been accepted by the Director by notice in writing to the Contractor or its Agent within __ days of delivery of such tender to the Director, the guarantee is void." In essence, it produces similar effect as Art 6. In fact if No. (2) is compared to No. (4), the latter gives an additional element of certainty by stating the number of days of delivery of the tender. The use of the phrase 'immediately cancelled' in No. (2) and 'void' in No. (4) are synonamous.

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16. Variation of guarantee

No. (4) clause (1) provides that if the tender (notwithstanding any acceptance thereof), made by the Agent differs in any material particular from the terms of the instructions given by the contractor to the agent the guarantee will be void. The variation in this case refers to the variation between a principal and agent, and the surety is discharged. Art 4 refers to variation by the principal alone. Unless the guarantor has informed the beneficiary about the variation, the modified guarantee will not stand. Therefore the Art gives protection to the beneficiary not the surety. No. (4), Art 4 will not discharge the surety. In the law of guarantee, the variation between the principal debtor and creditor would discharge the surety as illustrated by the following cases.

In Whitcher v. Hall (1826) 5 B & C 269; 108 E.R. 101, it was held by the majority (Bayley J. and Holroyd J., Littledale J. dissenting) that any variation in the terms of the agreement between the creditor and debtor which could prejudice the surety will, unless he consents thereto, discharge him from liability.

The leading case on variation of contract between creditor and debtor is Holme v. Brunskill (1877) 3 Q.B.D. 495. The surety joined in a bond to guarantee that the tenant of a farm would deliver up the farm and a flock of sheep thereon at the expiration of the lease. The lease was later varied without the knowledge of the surety by the surrender of a small field by the tenant in return for a reduction in rent. It was held that the surety was discharged since it was possible that the surrender of the field might have affected the tenant's ability to pasture the sheep and so to return them in good condition; and the surety might therefore have been prejudiced by the variation.[17]

As Art 4 does not give protection to the surety, he could be discharged by relying on the clause and also on the

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17. See also National Bank of Nigeria Ltd. v. Awoles [1964] 1 W.L.R. 1311.

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basis of the authorities just mentioned. It is immaterial that the variation in No. (4) is not between creditor and debtor. As long as the variation is in relation to the subject matter of the contract, and hence affects the liability of the surety, that would suffice.

17. Liability of the surety in collection of documents in support of a claim by the beneficiary?

Art 8 uses the phrase 'on their face to comply with the requirements of the guarantee'. Does it give protection to the guarantor? e.g. in the case whereby the signature on the document is a forgery, could the guarantor be indemnified from the principal? In connection with forgery of signature and also with the degree of care in examination of documents, a recent Privy Council decision on letters of credit will throw some light in solving this legal issue.[17a]

18. An analysis of specimen copies of performance guarantees in relation to RDUR

Art 2(b) defines a performance guarantee as an undertaking by the bank (guarantor) at the request of the supplier of goods or services or a contractor (principal) for erection or construction work, to furnish a guarantee to the buyer or employer (the beneficiary). The performance guarantee is for the protection of the beneficiary upon the principal's default in his performance. Furthermore, the guarantee could provide that the guarantor be given the option to either make payment to the beneficiary upon default or arrange to fulfill the performance of the contract.

Before proceeding on to examine the variations in the specimen copies of the performance guarantees, it is purtenant to note a House of Lords decision in a case on performance guarantee.

In Workington Harbour & Dock Board v. Trade Indemnity Co.[17b]

17a. See Gian Singh & Co. Ltd. v. Banque De L'Indochine [1974] 2 M.L.J. p.177.

17b. [1936] vol. 54 Lloyd's Report p.103 H.L.

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This is an action between the beneficiary (plaintiff) of the performance guarantee and the surety (defendant). The surety at the request of the contractors furnished a performance guarantee to the beneficiary for £78,785 (i.e. for the purpose of securing the performance by the contractors of their contract). The contractors failed to perform the contract and the beneficiary sued the surety on the basis of the performance guarantee.

The surety raised various defences against the beneficiary's claim.

(1) It was an insurance and void because the building owners had concealed from the insurers material facts.

(2) If it was a guarantee, there had been non-disclosure to the sureties of material facts by the building owners, including the fact that the building owners had made misrepresentations to the contractors by disclosing an insufficient part of the material facts, while not disclosing other materials facts at all.

(3) Third defence was based upon loan transactions which took place unknown to the surety between the beneficiary and the contractors (principals).

With reference to the first defence that it was a contract of insurance and not guarantee, the surety failed on that point both in the Court of Appeal and the House of Lords. Lord Justice Scrutton (C.A.) agreed with Mr Justice Lawrence that the transaction was a guarantee, not an insurance. Lawrence J. referred to Seaton v. Heath[17c] a decision of Lord Justice Romer to distinguish between insurance and guarantee. In insurance, the assured puts the risk before the insurer, while in guarantee the creditor does not himself go to the surety or represent or explain to the surety the risk to be run from the facts of the case, Lawrence J. was of the opinion that it was a guarantee and not insurance. Lord Atkin in the House of Lords also took a similar view.

17c. [1899] 1 Q.B. 782 at p.793.

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In relation to the second defence of non-disclosure by the beneficiary, the beneficiary made it clear to the contractors (principals) to ascertain for themselves all material facts relating to the conditions under which the contract would be performed. In short the beneficiary made it clear that it was not a disclosing body. The surety failed in this defence as the beneficiary in this case had freed himself from any obligation whether as to disclosure or misrepresentation.[18]

The surety succeeded on the third defence: Lord Atkin at p.118 said:

> "I think that the guarantors never came under any obligation in respect of the new uncontemplated burden of loans for £45,000, and are not liable for any sum in respect of such sum or interest."

19. When is a creditor/beneficiary required to disclose information to the surety

A contract of guarantee is not one of the class of contracts referred to as "a contract uberrimae fidea" i.e. of the utmost good faith. This means that the principal creditor (beneficiary) or the principal debtor need not disclose material information to the guarantor before he agrees to be guarantor.

Rowlatt on Principal and Surety, 2 ed p.10 said "a surety can only complain of positive deception, by representations express or implied."

In Cooper v. National Provincial Bank,[18a] the principal creditor (the bank) failed to disclose the following to the guarantor before he signed the guarantee:

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18. In relation to non-disclosure, the beneficiary was held not liable on the facts of the case. Lord Atkin did not think that it was necessary to look into general law as to disclosure in respect of guarantees. Contrast this with Lloyds Bank Ltd. v. Bundy [1974] 3 All E.R. 757. Also see Commentary on Halsbury Laws of England, 14th ed. Australia & N.Z. on ~~Banks~~ Banking para C177

18a. [1946] 1 K.B. 1.

(a) That the customer's husband was an undischarged bankrupt.

(b) That the husband had authority to draw on the customer's account which the guarantor was guaranteeing.

Laurence L.J. applied the principle set forth in Hamilton v. Watson (1845) 12 Cl. & F. 109 and held that the bank was under no duty to volunteer information about the customer's account to the guarantor, and the non-disclosure by the bank did not avail him.[19]

A further example is National Provincial Bank v. Glanusk[19a] - the customer was in a habit of overdrawing his account and the bank did not volunteer this information to the guarantor. Horridge J. held that the non-disclosure by a bank to the guarantor of a customer's overdrawn account of facts from which the bank has suspicions that the customer is defrauding him, does not discharge the guarantor. However, if the guarantor questions the banker (creditor) with reference to such matters as might help him to decide whether to accept his liability as guarantor, he must give a lucid reply not capable of being misinterpreted.

With reference to non-disclosure of information to the surety, this principle is applied less stringently to fidelity bond than guarantees in respect of bank accounting as exemplified by London General Omnibus Company v. Holloway[19b] The surety for the employee was aware that the latter had previously been guilty of dishonesty in his employment. But the employer cannot enforce the fidelity bond against the surety in respect of subsequent dishonesty of the employee, although the non-disclosure by the employer of the previous dishonesty of the servant was not fraudulent.[20]

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19. Lord Campbell in Hamilton said at p.119 "... I hold that it is quite unnecessary for the creditor, to whom the suretyship is to be given to make any such disclosure ..."

19a. [1913] 3 K.B. 335.

19b. [1912] 2 K.B. 72.

20. For a distinction between fidelity guarantee and guarantee for overdraft etc. see Farwell L.J. at p.82 of the case.

20. Could the surety ask for indemnity from the principal in relation to payment made to the beneficiary upon a fraudulent demand.

A case which illustrates a dispute between the principal and the surety in relation to indemnity from the former to the latter is Equitable Trust Company of New York v. Dawson Partners Ltd.[20a] This is a letter of credit case, but the principle is also applicable to bank guarantees.

In this case the bank (appellant) made payments to the seller (beneficiary) whose demand was fraudulent. The sale was for vanilla beans but the seller committed a fraud by substituting for the goods to be shipped, presumably after he had obtained a certificate of quality, a quantity of wood and iron with a small sprinkling of beans. One of the conditions on which the buyer undertook to reimburse the bank was that there should be presented to him (with other documents) a certificate of quality to be issued by experts who were sworn brokers. As this condition was not adhered to, the buyer was not liable to reimburse the bank. Applying this principle to bank guarantee, the principal is not obliged to indemnify the guarantor.

Performance Guarantees

With reference to no. (1) 'jointly and severally' is used. This means that the beneficiary could choose to sue anyone or both. The use of the word condition(s) in Nos. (1), (3) and (4) could suggest that 'condition' has a similar legal interpretation as in the law of contract. The enforcement period in No. (1) is five years, commencing on the date upon which the supply of X by the Board is first made available to the Developer (clause 3). This could be contrasted with Art. 5 RDUR which provides that a performance guarantee is to expire six months after the time provided in the contract for delivery or completion of work; or a month after the expiry of any maintenance period.

The phrase 'completion of work' could give rise to ambiguity. Is it ideal to take the opinion of a reasonable architect, contractor or local authority to determine the

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20a. [1927] vol. 27 Lloyd's Reports p.49.

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issue of what constitutes completion. Therefore it is submitted that unless the issue is resolved by making an express provision in the guarantee, a definite time limit of five years in No. (1) is more clear cut. It is to be noted that No. (1) uses 'demand' whilst No. (2) 'written demand. The latter by the addition of 'written' expressly rejects oral demand which no. (1) has left open.

No. (2) clause (1) provides that the written demand is for settlement of all losses, damages, costs, expenses or otherwise through the default of theexporter in performing and observing the agreements and provisions in the contract. It does not appear to be fair to theexporter if his default is due to circumstances not within his control. No. (4) clause (2) relieves the principal or contractor from liability under the guarantee in the event of delay or damage whether directly or indirectly arising out of war etc. Clause (2) in No. (3) is similar to clause (1) in no. (4) whereby an alteration in the obligation between the principal and the beneficiary does not release the guarantor's liability under the guarantee. This is a clause to protect the beneficiary as any material variation of the terms of the contract between the principal and creditor will discharge the surety in the usual course of things - Blest v. Brown.[20b]

The surety is relieved from liability by the creditor dealing with the principal debtor in a manner at variance with the contract, the performance of which is guaranteed - Ward v. National Bank of New Zealand.[21] Art. 4 RDUR also gives similar protection to the guarantor in the case of

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20b. (1862) 4 DeG.F & J. 367 at p.376.

21. (1883) 18 App. Cas. 755 P.C. at p.763. A similar view is adopted by Canadian Courts. See Dickson v. McPherson (1852) 3 Gr. 185 per Blake C, quoting Lords Cottenham and Brougham in Bonar v. Macdonald 14 Jur. 1077, 3 H.L. Cas. 226, 10 E.R. 87 "... any variation in the agreement to which the surety has subscribed, which is made without the surety's knowledge or consent, which may prejudice him, or which may amount to substitution of a new agreement for a former agreement and though the original agreement may notwithstanding be substantially performed, will discharge the surety."

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performance guarantee. Hence the clause not releasing the surety in the event of an alteration in the obligation of the guarantee has the effect of contracting out of Art 4 and also the common law rule. In the absence of an express contracting out provision in RDUR, it is doubtful whether contracting out of RDUR is permissible.

It is to be observed that Nos. (1) and (2) do not have provision to provide for dispute. The possible reason for the absence of dispute clause could be that the beneficiaries are governmental bodies. But this reasoning seems to run counter to Nos. (3) and (4) as the beneficiaries are also governmental bodies. The answer to this question is that the performance guarantees in the latter are from different countries.

The similarity between nos. (3) and (4) is the presence of a dispute clause in each of them (although with variation). The principal difference between them lies in the fact that in no. (4), 'heir" is added to executors, administrators, successors and assigns of the developer (or contractor) and surety.

<u>Is there a difference between heir and successor?</u>

'Heir" or "heir at law" is defined as the person entitled by law, to the real property of a deceased person who left no will.[22] On the other hand succession is the passing of property on death of a corporation solely to his successor.[23] Following from this, 'successor' apparently seems to apply more to corporate bodies rather than individuals as the use of the word 'ancestor' denotes a kind of blood relationship. There is no case in point, and until such time, the issue is left open.

In no. (3), the Corporation (beneficiary) has adopted a

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22. <u>Thomson's Dictionary of Banking</u>, p.305; P.G. Osborn - <u>"A Concise Law Dictionary"</u> 5 ed. 1964 at p.152.

23. Osborn - p.305 "For as the heir doth inherit to the ancestor, so the successor doth succeed to the predecessor."

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subjective test to determine whether the conditions, stipulations are complied with. This is so as could be reinforced by the phrase 'wholly in the opinion of the corporation ...'. When it comes to quantifying the claim, it is 'the amount of the bond that it considers necessary to remedy the default of the developer ..." (i.e. a subjective quantification by the beneficiary).

With reference to the question of damages, in the General Conditions of Contract issued by the Ministry of Works in New Zealand, application for liquidated damages is for delay in completion of the work. The payment or deduction (from any money in the contractor's hand or which may become due to him) of such damages shall not relieve the contractor from his obligations to complete the work or from any of his obligations and liabilities under the contract.[24] No. (3) seems to convey the idea that liabilities under the performance guarantee could be recovered as liquidated damages, thereby (apparently) the liabilities under the guarantee is extinguished.

From the above, it may be seen that greater protection for the beneficiary in performance guarantee could be achieved by enacting a subjective element into the guarantee.

In No. (4) clause (3), it is provided that any differences between the beneficiary and the surety are to be referred to the arbitrator for a decision. But, throughout the performance guarantee, the contractor and surety are referred to as two different persons. Hence, reference to surety alone in clause 3 to the exclusion of contractor seems a little unusual. In contrast to No. (3), access to the court for recovery of money by the beneficiary is upon the failure of the developer and/or the surety to pay the sum of money. The additional provision of a further arbitrator and umpire is a welcome feature ~~of~~ if this in actual fact would increase the efficiency in resolving disputes.

21. An analysis of Repayment Guarantee in relation to RDUR

Art 2(c) - defines a repayment guarantee as an undertaking

24. 13-12 p.8.

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by a bank (guarantor) to furnish a guarantee to the buyer or an employer at the request of the supplier or a contractor to protect the former from default by the latter.

An undesirable and impracticable feature about this particular specimen copy of repayment guarantee is that it is unwieldy to have to institute legal proceedings within a month in relation to a claim. In addition the guarantee is governed by the law of the surety, and furthermore the place of business of the undersigned branch of the bank shall be the place of performance of the surety's obligation. Last but not least the guarantee provides that all proceedings against the bank shall be brought exclusively before the courts having jurisdiction over the place.

With reference to the place of obligation of the surety, this is in full conformity with Art. 9.

This guarantee expressly provides for legal proceedings and not arbitration. Hence Art 10 is not applicable as it is concerned primarily with dispute and rights and obligations of the principal, guarantor and beneficiary in relation to arbitration.

22. Custom guarantees

As mentioned before, RDUR does not provide a definition for custom guarantee. In the area of custom guarantee, dispute could arise between the surety and the beneficiary (namely the customs department). This could be illustrated by a decision of the Supreme Court of Canada in Canada Surety Company v. R.[24a] In this case, the surety company gave a bond to the Crown pursuant to the customs Act to secure exportation of liquor at H. to Georgetown. The liquors never reached Georgetown, as the intended destination of the shipment was not Georgetown. A written certificate was later deposited with the collector of customs at H, purporting to come from the custom office at Georgetown, stating that the liquor had been delivered to the customs authorities there. The collectors of customs at H, believing the document to be genuine,

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24a. [1930] S.C.R. 434.

cancelled the guarantee and surrendered it to the surety company. But on discovery that it was a fraudulent certificate, the customs department instituted proceedings against the surety to recover the amount of the money guaranteed.

The unanimous decision (Anglin C.J.C., Duff, Lamont, Smith and Cannon JJ) of the Supreme Court of Canada was delivered by Duff J. The first issue for consideration was whether the act of the collector at H in delivering up the bond with the intention of cancellation, operated as cancellation of that document. The court was of the opinion that the surety company could not rely upon the collector's act in delivering up the guarantee with the intention of cancelling it, even assuming such delivery to have misled it to its prejudice. (Mayor etc. of Kingston-upon-Hull v. Harding)[24b] Even if the collector had been (contrary to the finding) a party to the fruad, a purported cancellation based upon it could as between the Crown and persons bound by the acts of parties implicated in the fraud, or civilly responsible for the non-observance of the law, have any effect as against the Crown.

The next argument put forward by the surety company was that the customs could only recover such damages as have been proved. Duff J. at p.441 says:

> "It is settled law, I think, that where a bond is given to secure the performance of the provisions of a revenue statute, the bond is forfeited if the condition is not performed, especially where the bond is required by the statute." 25

Last but not least the surety company argued that the object of the Act was to obtain a guarantee for the payment of penalties exacted by a certain section, and that the limitation clause of that section applies. Furthermore the surety company relied on another section, as showing that the claim was statute barred. His Honour however was of the opinion

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24b. [1892] 2 Q.B. 494.

25. The King v. Dixon (1822) 11 Price, 204 at p.211. The King v. Canadian Northern Ry. Co. [1923] A.C. 714 at p.722.

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that the words in another section which provided that "prosecutions or suits for the recovery of penalties or forfeitures imposed by this Act" did not embrace a proceeding upon a bond required by the statute.[26] Duff J. was of the view that the above phrase applied to penalties, seizure and forfeiture imposed directly by the Act rather than to guarantee bonds.

It is submitted that the Canadian approach is a strict interpretation of the Customs Act in favour of the Crown. Perhaps this is because it is a revenue statute. Although the surety has to bear the loss, he would be well protected by the security or funds given by the principal in most cases.

Another case which highlights the dispute between the customs department (beneficiary) and the surety is a New Zealand decision of The King v. Turnbull.[26a] The facts in this case were as follows: The surety (defendant) executed a bond to the crown in the sum of £1000 with a condition that it should be void if the full duties due on all goods in the warehouse occupied by O should be duly paid to the Collector of Customs, and if no goods were taken out of the warehouse until cleared and payment of duty was made. It was admitted that the conditions of the bond had been broken but the surety relied on a plea that non-payment of duties was only possible by the fraud and collusion of the customs officers, It appeared that the goods which were dutiable had passed through the customs as free goods by the fraud of O in collusion with a customs house officer, and it was claimed that such collusion discharged the surety from his obligations under the bond.

The reasoning of Denniston J. was based substantially on Bowen L.J.'s judgment in Mayor etc. of Kingston-upon-Hull v. Harding[26b]:

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26. There is no equivalent of this provision in the New Zealand Custom Act 1966.

26a. (1914) 17 G.L.R. 249.

26b. [1892] 2 Q.B. 494 at p.504.

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> "The broad principle of law, which is at the root of our decision is that a surety cannot claim to be discharged on the ground that his position has been altered by the conduct of the person with whom he has contracted, where that conduct has been caused by a fraudulent act or omission against which the surety by the contract of suretyship has guaranteed the employer. This seems to me good sense, and I think it is good law."

His Honour rejected the proposition that direct connivance or collusion by the obligee for whose security the protection was given with the person for whose good conduct the security was given would discharge the surety - Phillips v. Foxall[26c] Denniston J. was of the view that a man was civilly liable for consequences of the fraud or misconduct of his agent or servant in the ordinary course of his business. He emphasised that the object of taking security for the good conduct of such servant or agent was to protect the employer from all consequences to him of such misconduct.

The condition of a custom bond is absolute and general. It is a condition that full duties are to be paid on all goods warehoused, and that no part thereof unless duty is being paid. The main rationale of Denniston J's decision is that the bond is made to the crown whose object is protection against loss of revenue through default of payment of duty.

The New Zealand approach is similar to the Canadian approach as the judges in both cases relied heavily on Mayor's case. The courts in both jurisdictions were influenced to a fair extent that the guarantees were made to the crown and also that the suretyships were subject to a revenue statute.

Variations in the specimen copies of custom guarantees

It is to be observed that out of six specimen copies of custom guarantees[27] from various countries, only Nos. 3

26c. L.R.7 Q.B. 666.

27. The sixth one is taken from Canadian Surety Company v. King supra at pp. 438, 439.

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and 6 bind not only the surety, but also "heirs, executors, administrators, successors and assigns" in the former, whilst the latter only includes "our successors and assigns". Thus it could be seen then No. 3 is very comprehensive and therefore gives more protection to the customs department. But in practice, if the custom guarantee is given by the bank, it should be quite safe.

23. Legal analysis of bank guarantees

23-1 Liability of surety under a performance guarantee with provisions that the surety will complete the work of the contractor upon the latter's default.

The case in point is a Canadian decision of Lunenburg Homes for Special Care Corporation v. Duckworth.[27a]

The plaintiff (beneficiary) entered into a contract with contractor (principal) to construct a senior citizens home as 'Harbour View Haven'. The performance bond was executed by contractor as principal and by the defendant as surety in favour of the plaintiff (beneficiary). The guarantee provided that upon the default of the contractor the surety would complete the work in the contract.

The contractor fell into financial difficulty and abandoned the work with numerous mechanic's lien against the Home. The plaintiff terminated his contract with the contractor and notified the surety of the contractor's default. The surety denied liability under the guarantee and put forward two defences:

(1) By Art. 37 of the contract between beneficiary and principal (contractor), the former was entitled to recover money from the contract if the claim was supported by an architect's certificate. But in the absence of the certificate, the beneficiary had no right to recover.

(2) That failure to employ an architect and to have an

27a. (1973) 33 D.L.R. (3d) 711 (N.S.).

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architect's certificate as to expenses incurred by the plaintiff (beneficiary) in completing the building amounted to substantial and material alteration to the main construction contract, sufficient to relieve the surety's obligation under the performance guarantee.

Cowan C.J.T.D. was of the view that if under a performance guarantee, the surety undertook on default of the principal to complete or to obtain completion of the contract, his obligation was independent of the principal contract. Hence if the surety did not fulfill his undertaking to complete the work abandoned by the contractor, the former breached an independent contract. Thus he was not entitled to insist on compliance by the beneficiary with the requirement of the principal contract.

His Honour distinguished De Mattos v. Jordan by pointing out that that was an ordinary case of performance bond which was simply conditioned upon due performance by the principal contractor of a contract. (The beneficiary in Mattos could not recover the money in the absence of an architect's certificate as required in the guarantee).[28]

Another case to illustrate the liability of a surety under a performance guarantee is Town of Truro v. Toronto General Insurance Co.[28a]

The insurance company (defendant) furnished a performance guarantee to Town (beneficiary) to guarantee performance of contractor. The work was substantially completed, but unfortunately the contractor fell into financial difficulty. In the meantime, Town had assigned its right in the contract to the Board. The Town borrowed from the bank to complete the work, and was later reimbursed by the Board. The former sued the surety (i.e. the insurance company) for the money but failed in the Supreme Court of Nova Scotia, Appeal Division gave judgment to the surety. Town appealed

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28. For reasoning of Cowan C.J.T.D. see (1973), 33 D.L.R. (3d) 711 (N.S.) at pp. 715, 716.

28a. 38 3 D.L.R. (3d) 1.

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to the Supreme Court of Canada on three grounds:

(1) That the court below was wrong in finding that there was an assignment by the Town to the Board of the prime contract between the Town and the Contractor.

(ii) That the event occurred between March 1970 and October 1970 did not constitute a variation of the contract.

(iii) No distinction between compensated and non-compensatory surety.

Dickson J. delivered the unanimous decision of the full court and found in favour of the beneficiary (Town), that where a surety guaranteed to an owner (Town) who had entered into a building contract with a contractor the performance of contract between the contractor and his subcontractors, the surety was not discharged by any change in the contract between the beneficiary and the contractor (principal).[29]

A third case which concerns a dispute between beneficiary and surety is Thomas Fuller Const. Co. v. Continental Insurance Co.[29a] This was a decision of Houlden J. in Ontario High Court whereby judgment was for the plaintiff (beneficiary).

The subcontractor (principal) requested the (surety) defendant to furnish a performance guarantee to the contractor (beneficiary) to secure the due performance of the subcontractor. The latter defaulted and the beneficiary sued the surety for the money under the guarantee. The latter raised three interesting defences:

(1) The beneficiary did not notify the surety of the principal's default which prejudiced the surety and made the guarantee void.

(2) The beneficiary authorised progress payments to the principal in excess of the amount of work done. The

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29. Town of Truro 38 D.L.R. (3d) 1, see Dickson J.'s reasoning at p.7-10.

29a. [1973] 3 O.R. 202; 36 D.L.R. (3d) 336.

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surety was prejudiced by these payments and hence the guarantee was rendered void.

(3) Even if the surety was liable, many of the items claimed by the beneficiary as damages were improper.

Houlden J. approached the case by looking at the word 'default' which according to His Honour was capable of a very wide meaning and could also cover a very slight delay on the part of the subcontractor.

Then His Honour discussed the general principle to be applied in interpreting a bond. He referred to Bovill C.J.'s judgment in Coles v. Pack.[30]

The third step of Houlden J.'s reasoning was that two conditions had to exist before the bonding company was called upon to act -

(a) default by subcontractor, whereby the default was of a serious nature; and

(b) a declaration by the beneficiary that the default had occurred.

But regarding the above two conditions His Honour said:

> "... The only practical and sensible basis, in which bonding can be done on large construction projects is by permitting the general contractor to be the judge of when the default by a subcontractor is sufficiently serious that the bonding company should be called in with the resultant disruption of the contractor's contract." 31

Thus the Court adopted a subjective opinion of the

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30. (1869) L.R. 5 C.P. 65 at p.70. "The document in question, like every other guarantee, must be construed according to the intention of the parties as expressed by the language they have employed, understanding it fairly in the sense in which it is used; and this intention is best ascertained by looking to the relative position of the parties at the time the instrument is written" - 36 D.L.R. (3d) 336 at p.350.

31. 36 D.L.R. (3d) 336 at p.351.

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contractor to decide whether the default was sufficiently serious on the basis of business efficacy.

The most interesting point in Houlden J.'s judgment is that if there is an ambiguity, the usual rule of construction contra proferentem would not apply. This is in direct conflict with the usual construction of guarantees.[32] The two reasons in support of the non applicability of contra proferentem were that (1) the bond was prepared by the bond company and (2) the contractor (beneficiary) was given a discretion of determining when a default was of such a nature that notice was required to be given to the bonding company.[33]

The Court was of the view that the beneficiary was not required to give notice of default by the principal to the surety based on the following:

(1) business efficacy

(2) American Restatement of the law of Security s.136 which states the general principles

(3) English rule - 18 Hals. 3rd ed. p.449 "Notice of the principal debtor's default need not be given to the surety." 34

With reference to the second defence, in order to discharge the surety, the beneficiary would have to knowingly overpay the principal <u>Warre</u> v. <u>Calvert</u>[34a]; <u>Calvert</u> v. <u>London Dock Co</u>.[34b]

If overpayment was received as a result of fraud on the part of the principal, the surety was not released, <u>Mayor</u>[34c]

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32. Is this point going to be a distinguishing feature between bank guarantees and other guarantees?

33. 36 D.L.R. (3d) 336 at p.352.

34. <u>Ibid</u> p.353.

34a. (1837) 7 Ad & El, 143; 112 E.R. 425.

34b. (1838), 2 Keen 638; 48 E.R. 774.

34c. [1892] 2 Q.B. 494.

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Even if the beneficiary was negligent in overpayment still ~~security~~ the surety is not discharged. - MacTaggart v. Watson[34d], approved by the Supreme Court of Canada in London Guarantee & Accident Co. Ltd. v. City of Halifax.[34e]

Is a surety's liability bound by architect's finding.

A case to illustrate this point is Powell River Paper Company Ltd. v. Well's Const. Co. and American Surety Company.[34f]

The facts were that a contract for the execution of certain work was guaranteed by the bond of a surety company, conditioned to indemnify the plaintiff (beneficiary) against loss or damage by reason of failure of the construction company (principal) to perform its contract. The contract provided that in certain circumstances, the work might be taken out of the hands of the construction company, and executed by the beneficiary. The cost and charges there to be ascertained by the architect and paid for by the construction company (principal).

It was held (by a majority decision of Macdonald C.J.A. and Irving J.A.) that the surety company was not bound by the decision of the architect as to the cost of executing the work by the beneficiary. Therefore the surety company was entitled to particulars of the beneficiary's loss and damages in executing the work taken over from the construction company.

The reasoning of the majority's finding was that the surety company did not decide to have the architect established as a tribunal to settle differences between the parties.[35]

34d. (1835) 3 Cl & Fin 525 H.L.; 6 E.R. 1534.

34e. [1927] S.C.R. 165, [1927] 1 D.L.R. 1129.

34f. (1912) 17 B.C.R. 37.

35. (1912) 17 B.C.R. 37 at p.39.

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Galliher J.A. (dissenting) based his decision on the interpretation of the contract. His Honour said:

> "There is a provision in the contract that the loss shall be for a specified sum or ... to be found by the architect ...." 35a

Another case to highlight the liability of the surety under a performance bond is Calgary Milling Company Limited v. American Surety Company of New York (def)35b

In addition to the usual factual situation, the building contract provided for payment of a lump sum by the owner (beneficiary) to the contractor in instalments of all wages for labour and sums paid for material upon production of certified accounts etc. "provided that the total amount so paid ... during the progress of the work ... shall not exceed a sum equal to 80% of the amount of work done and material furnished on the premises at the contract price." The owner was authorised to retain 20% of the money payable to the contractor.

The unanimous decision of Viscount Haldane, Lords Buckmaster, Dunedin and Shaw was delivered by Lord Dunedin in favour of the beneficiary. Their Lordships gave a wide interpretation[36] to the proviso, and held that the owner was to make payment for all work certified as actually done and materials as actually supplied, provided that the total of such payments did not exceed 80% of the total contract price. Furthermore, the surety was estopped from objecting that the owner, in accepting the surety's view had in certain payments only paid the 80% to the contractors, which was based on the fact that upon enquiry by the owner, the surety had expressed the view that 20% of every payment should be retained.

A provision of the contract was that in the case of discontinuance of the employment of the contractor, he was not entitled to receive any further payment until the work should be finished. This did not disentitle the owner

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35a. (1912) 17 B.C.R. 37 at p.40.

35b. [1919] 3 W.W.R. 98, 48 D.L.R. 295.

36. [1919] 3 W.W.R. 98 at p.103.

as against the surety, after such discontinuance to honour assignments of money given by the contractor. The reason being that the amount of which assignment had been taken into account in paying the contractor up to 80% at a time prior to such discontinuance.

Another case in the area of performance guarantee which demonstrates the legal dispute between the beneficiary and the surety is Niagara and Ontario Construction Co. v. Wyse and United States Fidelity and Guaranty Co.[36a]

In this case, the surety lost in his first two defences but succeeded in his third defence against a claim by the beneficiary. The first two defences were based on alteration of contract. Annexed to the bond was a copy of the contract in question, which however did not contain some slight alterations made on the final revision of the contract. This was re-executed by the parties after the date of the bond. The surety was not relieved from liability if words inserted did not alter the meaning of the contract in any way, since the surety was not prejudiced by an immaterial alteration.

The surety argued that the subcontractor's letter waiving any claim for damages which might arise out of delays or interruptions in the performance of a contract constituted alteration of the contract. But according to Middleton J., it did not constitute any material change in the contractual obligation of the parties or enlarge the liabilities of the surety so as to discharge the surety.

The final successful objection by the surety was that there was no default by the subcontractor under the guarantee, where he had completed his work and performed his contract with the assistance of advances made to him, by the contractor. His Honour was of the opinion that the contractor (beneficiary) could not recover these advances from the surety of the subcontractor whose bond was for due performance of the work. The advances were not within the conditions expressed in the bond. But if the contractor had completed the work on his own account upon the subcontractor's default

36a. 10 D.L.R. 116; (1913) 24 O.W.R. 302

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and charged the cost thereof against the subcontractor deducting from this amount the sum due under the contract, the surety would still be liable, provided the surety had been notified as required by the contract.[37]

Last but not least the surety in Brisbane City Council v. Law Union and Rock Insurance Co. Ltd.[37a] also endeavoured unsuccessfully to deny liability based on variation of contract. The facts were that by an agreement, the terms of which were set out in a letter, whereby a local authority agreed to do certain work for a company at a price of £1547. The work to commence on 28 February, £600 to be paid on that day and the balance at £300 per month. The local authority required a surety to furnish a performance guarantee to the effect that if default was made in payment, the surety was to pay the full price or so much thereof as was at any time owing. There was no mention in the bond as to the date the work was to commence. The company defaulted in its payment to the council (beneficiary). But the council had commenced work on the 26th April and did the work in two sections. One was paid by the surety whilst the other was not.

E. A. Douglas J. and Hart A.J. (Brennan J. dissenting) held that the agreement should not be incorporated in the bond. The whole court held that the council was not obliged to commence the work on or before 28 February in order to make the surety liable. In addition, there had been no material alteration or variation of the agreement, or the creation of new agreement which would release the surety.

23-2 Right of the surety against the beneficiary

The Employers Liability Assurance Corporation Ltd. v. R.[37b] The plaintiff (surety) in this case filed an action to recover $15,740 together with 5% interest from the Crown

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37. 10 D.L.R. 116 at p.121

37a. (1934) Q.S.R. 242.

37b. [1969] 2 Ex C.R. 246.

(beneficiary). The plaintiff (surety) was the surety of two bonds supplied in respect to a contract between the Crown (beneficiary and the corporation (principal) for the construction of 220 houses. The two bonds were for performance of the contract and payment of labour and materials supplied. The corporation (principal) which had received $356,250 on the contract, became bankrupt and abandoned the contract. The surety of the bond was then required by the Crown to complete the contract. He paid $282,354 for labour and materials and the Crown paid a further $87,613 to complete the construction of the houses. There remained $150,595 of the money appropriated for the contract. Of that sum, the Crown retained $15,140 for exercise tax due by the corporation to the Crown in an unrelated matter and paid the balance of $134,855 to surety.

Gibson J. found for the surety. The money appropriated for the contract stood on the same footing as securities in the hands of a creditor received from the principal debtor to which a surety was entitled in equity after making good a guarantee to such creditor.[38] The Court also allowed the principles of the law of surety, creditor and principal debtor.

Right of the surety against beneficiary based on "conclusive evidence" clause in the bank guarantee

The authority on this aspect of the law pertaining to bank guarantees is *Bache & Co. (London) Ltd.* v. *Banque Vernes et Commerciale de Paris S.A.*[38a]

The plaintiffs, who were brokers, demanded a bank guarantee before entering into buying and selling transactions on behalf of their customer, a French trading company. The defendants, who were the trading company's bankers, gave the guarantee which contained a conclusive evidence clause providing (inter alia):

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38. [1969] 2 Ex. C.R. 246 at p.255. His Honour relied on *In re Sherry* (1884) 25 Ch.D. 692 per Selborne L.C. at p.702.

38a. [1973] 2 Lloyd's Report p.437.

> "Notice of default shall from time to time, be given by [plaintiff] to [defendant] and on receipt of any such notice [defendant] will forthwith pay ... the amount stated therein as due, such notice of default being as between [plaintiff and defendant] conclusive evidence that [defendant's] liability hereunder has accrued in respect of the amount claimed."

The guarantee was to be construed according to and governed by the laws of England.

The plaintiff carried out various transactions for the trading company and alleged that a considerable balance was due to the plaintiff.

The trading company failed to pay and a notice of default was served on the defendant. The defendant refused to pay and the plaintiff sued the defendant. The court found for the plaintiff. The defendant appealed to the Court of Appeal on the grounds that the amount claimed was not correct and the conclusive evidence clause was contrary to public policy and invalid because it:

(i) attempted to oust the jurisdiction of the courts, and

(ii) made the brokers judges in their own cause.

The unanimous decision of the Court of Appeal (Lord Denning M.R., Megan and Scarman LJJ) held that, as a matter of principle, the conclusive evidence clause was binding according to its terms and, if notice of default was given in pursuance of the conclusive evidence clause it was binding according to its terms. The clause was not contrary to public policy because it was the commercial practice for such bank guarantees to be demanded and the French bank could debit the sum from their customers.[39] Furthermore, if the figure should be erroneous, it was open to the trading company to have it corrected by instituting proceedings against the London brokers.

The court applied the High Court of Australia decision

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39. [1973] 2 Lloyd's Report p.437 at p.440 col. 1.

in Dobbs v. National Bank of Australasia.[40]

It is interesting to note Lord Denning's reasoning.[41]

Regarding the point of cross claims, perhaps it is of interest to compare and contrast his reasoning in Elian v. Matsos.[42]

Right of surety against the beneficiary

The second case in point is Purcell v. Raphael[42a] The plaintiff by bond became surety for a builder (principal) that he would erect a house for the defendant, or that the plaintiff as his surety would do so. The builder failing to complete the house after some labour, the plaintiff finished the house. The builder then became insolvent, and the defendant, being called upon, paid the builder's assignee the whole contract money.

It was held (by Stephen C.J., Cheeke J. and Faucett J.) that there was no privity between the plaintiff and the

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40. [1935] 53 C.L.R. 643. Lord Denning drew further support from Halsbury's Laws of England, vol. 15 at p.278. "... the tendency of evidence which by statute or by agreement of the parties is declared to be conclusive, precludes evidence.to the contrary, which is inadmissible unless the evidence adduced is inaccurate on the face of it or fraud is shown.

41. [1973] 2 Lloyd's Report p.437 at p.440 col. 1. Per Lord Denning. "This commercial practice of (inserting conclusive evidence clauses) is only acceptable because the bankers or brokers who insert them are known to be honest and reliable men of business who are most unlikely to make a mistake. Their standing is so high that their word is to be trusted so much so that a notice of default given by a bank or a broker must be honoured. It ranks as equivalent to, if not higher than, the certificate of an arbitrator or engineer in a building contract. Therefore such a certificate must be honoured, leaving any cross-claims to be settled later by an arbitration."

42. [1966] 2 Lloyd's Report 495, C.A. This case will be dealt with later under "injunction".

42(a) (1867) 7 S.C.R. (N.S.W.) 135

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defendant, and that the plaintiff could not recover in an action brought by him on a promise by the defendant to pay them for the work done.[43]

Could the surety after fulfilling the principal's obligation recover from the beneficiary by suing through the Official Assignee of the ~~building~~ builder (principal)

An example of this fact situation is Sandeman v. Cohen.[43a] The contractor (principal) made a contract with the defendant (beneficiary) to build an hotel for him, and the due performance by the contractor of his agreement was secured by a performance guarantee. The contractor became insolvent and the work was completed by the surety. The defendant (beneficiary) was, under the contract, bound to pay a final balance of 25% on the value of the whole work. The plaintiff sued the defendant for this amount (for the benefit of the surety).

Sir James Martin C.J. found that the surety was not obliged to complete the work and that the beneficiary had no right under the guarantee to call upon him to do so. The surety did so under the notice given to him by the beneficiary. This constituted a new binding contract independent of the guarantee. In addition as the work done by the surety constituted a new agreement, divorced from the original guarantee, the plaintiff (official assignee of the principal) could not sue for surety's beneficiary as this was no concern of his.

Although Hargrave J. concurred with the Chief Justice that the plaintiff could not recover from the defendant, his reasoning was opposed. His Honour was of the view that no new contract was made when the surety completed the work of the contract. The only question was whether any liability existed for the defendant to pay the plaintiff. Hargrave J. refused recovery by the plaintiff for the benefit of the surety

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43. For Stephen C.J.'s reasoning (1867) 7 S.C.R. (N.S.W.) 138 at p.141. Faucett J.'s reasoning in finding against the surety was based on his recourse against the principal. But it is submitted that this remedy only existed in theory but was not practically feasible as the principal was a bankrupt.

43a. (1877) Knox 371.

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on the basis that there was no privity of contract between the surety and the beneficiary.[44] Secondly, he rejected the new idea that an official assignee could sue as trustee for a third party.

Faucett J. (dissenting) agreed with Hargrave J. that the work was done by the surety under the deed (guarantee), as evidenced by the notice given by the defendant to the surety to complete the work.[45] Per Faucett J.[46]

> "He does it for the original contractor and to avoid the penalty."

Although His Honour made it clear that an Official Assignee could not sue as trustee for anyone except the creditors estate. Nevertheless he held that there was no justification to allege that the Official Assignee was suing as trustee for the surety. Apparently Faucett J. found for the plaintiff, although expressing some doubt in relation to his own judgment.[47]

The Chief Justice's finding that the completion of the work by the surety was a new contract with the beneficiary, was consistent with Cowan C.J.T.D's reasoning in Lunenburg Homes for Special Care Corporation v. Duckworth,[47a] at p.32 that this obligation was independent of the principal contract. His Honour expressly pointed out the difference between an ordinary case of performance bond, which was simply condtional upon due performance by the principal contractor of a contract, and a performance guarantee whereby the surety promised to complete the work if the contractor (principal) defaulted.[48]

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44. (1877) Knox 371 at p.375 - per Hargrave J. If the surety is obliged to honour the performance of the contract on default by the principal (as there is no new contract) does this not create a contractual nexus between the surety and th beneficiary (def).

45. That decision was arrived at by Faucett J. at p.375 notwithstanding that the surety was under no obligation to complete except to pay ₤250.

46. (1877) Knox 371 at p.375.

47. Ibid p.375 per Faucett J. "I speak with hesitation and might agree with their Honours if I had more time to conside

47a. (1973), 33 D.L.R. (3d) 711 (N.S.).

48. (1973) 33 D.L.R. (3d) 711 (N.S.) at p.715-719.

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23-3 Right of the principal to recover from the surety upon fraudulent misrepresentation by the beneficiary.

In the letters of credit case of Basse and Selve v. Bank of Australasia[49] the buyer (principal) brought an action to recover money paid by the bank (surety) to the seller (beneficiary) upon a fraudulent misrepresentation by the seller. The seller sent worthless ore instead of what was bargained for.

Bigham J. held that as the document presented by the seller was regular on its face, and came within the meaning of the mandate, there was no duty on the bank to see to the sampling. Thus it was entitled to assume that the analyst had acted skilfully in making the analysis.

Right of the principal to recover from the third party upon forged documents

An example of this sort of situation is Guaranty Trust Co. of New York v. Hannay & Co.[50] A buyer of cotton had instructed his agent (bank) to undertake personal liability to a third party (discounting house). The agent had paid to an assignee (Midland Bank) of the third party on the ground of this liability, though the buyer maintained that he was not liable and had instructed him not to pay. The buyer had indemnified the agent (bank) against such payment. He then sued neither the agent nor the person whom the agent had paid, but the original third party (discounting house), alleging some promise or representation to the buyer on which the buyer could sue.

The court found in favour of the third party that the latter by presenting the documents for acceptance did not warrant or represent them to be genuine. Thus the buyer could not recover the money paid to the third party (discounting house)[51]

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49. (1904) 90 L.T. 618.

50. [1918] 2 K.B. 623 C.A.

51. In case of false documents, the buyer could not be held to have authorised payment against such documents. Re Salomon & Co. and Naudszus 81 LT 325; Robinson v. Reynolds (1841) 2 Q.B. 196 decided that neither could a banker be forced to pay against documents which he knew to be false. But if he had given his acceptance he would be liable to a holder in due course. See also Thiedemann v. Goldschmidt (1859) 1 De G.T. & J. 4; 45 E.R. 260.

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23-4 The contractual relationship between the principal (customer of the bank) and the surety (the bank giving the guarantee)

As Lord Denning has pointed out in Elian v. Matsos,[52] the bank guarantee is very much like a letter of credit, therefore it will also follow that the contractual relationship between the issuing banker and buyer (principal) is defined by the terms of the agreement between them under which the letter opening the credit (guarantee) is issued. As between the seller and the banker, (beneficiary and surety) the issue of the credit (guarantee) duly notified to the seller (beneficiary) creates a new contractual nexus and renders the banker directly liable to the seller (beneficiary) to pay the purchase price or to accept the bill of exchange upon tender of the document (to fulfil the obligations of the principal on his default).[53]

On the basis of the contractual relationship between the principal and the bank (surety), the principal must try his best to avoid default on the primary obligation (i.e. to prevent a claim from arising under the guarantee).

If a claim materialises against the surety, the principal is required to compensate the surety for all the expenses incurred and also the amount paid to the beneficiary on the strength of the guarantee.

The recourse of the surety against the principal is by way of (1) subrogation, and (2) on the basis of contractual relationship between the surety and the principal.

Subrogation

When a surety has paid a debt to a creditor, he is entitled in equity to be subrogated to all the rights possessed by the creditor.[54] The right of the surety arises from the

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52. [1966] vol. 2 Lloyd's Report 495 C.A. at p.497.

53. Guaranty Trust Co. of New York v. Hannay & Co. [1918] 2 K.B. 623 at 659, C.A. per Scrutton L.J.

54. Re Lord Churchill, Manistry v. Churchill (1888) 39 Ch.D. 174 per North J.

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the contract of guarantee, and commences from the time of his becoming a surety, not merely when he discharges the obligation of the principal debtor.[55]

The surety is entitled to have transferred to him any securities which the creditor has taken from the debtor, so as to help him recoup himself. Forbes v. Jack (1882), 19 Ch.D. 615 at p.621 per Hall V.C.:

> "The principle is that the surety in effect bargains that the securities which the creditor takes shall be for him, if and when he shall be called upon to make any payment, and it is the duty of the creditor to keep the securities intact ...."

The principle of subrogation applies only on payment by the surety but not prior to payment - Re Howe, Ex Parte Brett[56]:

> "... a surety is not entitled to the securities which the principal creditor may hold until he pays the debt. He has no bargain that the securities shall be given up to him, and it is merely after he has paid in full that the rule of equity comes in and says that he is entitled to the securities. But until payment, the securities are in no sense securities on property of his."

The right of the surety (on payment of the principal's debt) to the benefit of all the securities applies to, whether known to him or not at the time when he became surety.[57]

The securities given by the principal debtor to the creditor could be assigned to the surety upon payment but not available to the bankrupt.[58] The surety's right to the securities is not dependent on whether or not they existed at the time when the guarantee was given.[59]

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55. Dixon v. Steel [1901] 2 Ch. 602 at p.607 per Cozens Hardy J. "It certainly is not the law that a surety has no right until he pays the debt due from his principal"

56. (1871) 6 Ch. App. 838 at p.841 per Mellish L.J.

57. Forbes v. Jackson (1882) 19 Ch.D. 615.

58. Ex parte Crisp (1744) 1 A & K. 133.

59. Scott v. Knox (1838) 2 Jo.Ex.Ir. 778; Pledge v. Buss (1860) John 633.

In New Zealand, s.84 of the Judicature Act 1908 provides that a surety who discharges the liability is entitled to assignment of all securities held by the creditor. This is in line with previous authorities in relation to this point.

With reference to security Lord Selborne L.C. in re Sherry, London and County Banking Co. v. Terry[60] has this to add:

> "... moneys which by contract are appropriated to a particular purpose stand as regards the surety on the same footing as securities."

If the creditor assigns the guaranteed debt and the securities for the debt, the assignment is subject to the obligations to preserve the securities for the benefit of the surety.[61]

From the above discussion, the law is clear that a surety, making payment to the creditor, pursuant to the terms of his bond is subrogated to all rights of the creditor against the principal. But is there any authority to justify an extension of this well settled principle, so as to enable the surety to pursue, by way of subrogation, rights accruing to the creditor against a third party based on a default not covered by the guarantee, on which the surety paid, even though that default may be said to have contributed to the failure of the principal?

The case which highlights this complication concerning rights of subrogation of a surety is Prince Albert (plaintiff) Respondent v. Underwood, McLellan & Associates Limited (defendant) Appellant. C.A.[62]

This action was an appeal by a third party to the bond to prevent subrogation by surety (defending under the name of the

60. (1884) 25 Ch.D. 692 C.A. at p.702

61. Wheatley v. Bastow (1855), 7 De G. M & G. 261 at p.279 per Turner L.J.

62. (1967) 61 W.W.R. 577.

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beneficiary). The appellant (engineering company) agreed to provide engineering services and supervision for the construction for respondent (beneficiary) of a water reservoir. A contractor was engaged for this purpose and a performance bond was furnished by the surety company to the respondent, (beneficiary). Between the engineering company and the contractor there was no privity of contract. During construction part of the reservoir collapsed, and the beneficiary terminated the contractor's contract. The collapse was partly due to lack of proper supervision by the appellant. The work was completed by another firm but beneficiary claimed from the original contractor and his surety the extra cost involved. The surety paid the cost and obtained indemnity from the contractor (principal). There were written agreements between the beneficiary and the surety, and between the surety and the principal which provided, inter alia, that the surety might enjoy, by subrogation, all rights accruing to the beneficiary by reason of its contracts with the contractor and with the engineer (appellant) and might sue in beneficiary's name. The majority found for the appellant, i.e. the surety had no right to subrogation against the engineering company which was a third party to the guarantee. The court applied the English decision of Castellain v. Preston.[63]

The dissenting judgment of Wood J.A.[64] was based on the interpretation of the agreement between the surety and the beneficiary which contemplated the prosecution of the beneficiary's claim against the engineer. The whole arrangement was designed to guarantee recovery by the city of such amount as the court should award and to litigate the claim of the beneficiary against the engineer.

The majority in adopting a conceptual approach refused subrogation by the surety on the basis of lack of privity of contract between the contractor (principal) and the appellant

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63. (1883) 11 Q.B.D. 380; 52 L.J.Q.B. 366. For reasoning of the majority delivered by Maguire J.A. on the point of subrogation see (1967) 61 W.W.R. 577 at pp. 591, 592.

64. ibid p.578, 579.

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engineer (third party), and also because of the absence of authority to justify the extension of the principle of subrogation. The dissenting judge took a pragmatic approach so as to give effect to business efficacy.

The second recourse for the paying banker could be based on the contractual relationship with the customer. Upon this relationship, the bank (guarantor) has a claim for compensation for expenses, which flows from the issuing of the guarantee. This avenue of recourse against the customer (principal) is extremely valuable to the bank if it has paid or is obligated to pay as guarantor although the claim under the guarantee is doubtful or without foundation.[65]

23-5 Rights of the beneficiary under the guarantee for payment

This would normally depend on two things, namely:

(1) whether it is a three or four party guarantee;

(2) whether it is a simple or first demand guarantee or otherwise.

In a three party guarantee, the beneficiary could look to the surety for payment. But in a four party guarantee, whether the beneficiary could demand payment from the intermediary banker would, in most cases, depend on:

(a) Whether the intermediary banker acts as a "post office" i.e. he informs the beneficiary of the guarantee, and also makes payment on behalf of the instructing banker, or

(b) The intermediary banker has issued the guarantee and also simultaneously does not accept the full responsibility of it.

At this stage, a comparison of specimen copies of four party guarantees is made, to illustrate their variations - in words, and hence the possible different legal implications.

65. For details see Prof. Von Cammerer's paper on Suretyships and Bank Guarantees in Foreign Trade at pp. 7-10.

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It is to be noticed that No. (3) is a clear case that the intermediary bank is merely acting as a "post office" i.e. makes payment to the beneficiary under the guarantee issued by the instructing bank. The above conclusion is based on these words: "In the event that the occasion arises to avail of this facility, payment will be made to you by X3 bank in Y3 country against presentation of your simple receipt ...".

The remaining three guarantees show that in most cases the intermediary banks would issue the guarantee which would be under the full responsibility of the instructing/ issuing banks and not the intermediary bank.

Prima facie a guarantee of this nature would appear very "~~nosy~~ rosy" to the beneficariy as he may not be aware of the possibility of not having any legal redress against the intermediary banks.[66] Possibly in practice if a claim does arise, the intermediary bank will pay as a post office to the beneficiary and then obtain reimbursement from the bank. This is indicated in No. (4) "In consideration of our issuing any guarantee on your behalf, your counter guarantee towards our bank should be unconditional and irrevocable and clearly indemnify us against any loss or damages in all consequences ..."

But in theory it is submitted that the intermediary bank is not obliged to make payments to claims and the intermediary bank merely adds its name to the guarantee, expressly stating without incurring responsibility. Hence if for some unusual reasons the instructing/issuing bank is not able to indemnify the intermediary bank, the latter is not legally obliged to pay the beneficiary if it decides not to do so. But in reality this type of situation seldom occurs, and therefore the risk of non payment to the beneficiary is likely to be a mere possibility rather than a normal

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66. The usual phrase used in this sort of guarantee is "We request you to be so kind as to issue under our responsibility ... a Bank Guarantee in favour of ..." No. (1) and No. (2). "... we should be obliged if you would kindly issue under our responsibility in favour of ... an undertaking ... for the due fulfilment of the contract."

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occurrence.

Irrespective of whether it is a three party or four party guarantee, the suretyship is conditional. The usual proposition that the surety is liable only to the extent that the primary debtor is liable does not apply to a simple or first demand guarantee. In this sort of guarantee, the primary debtor could not object to payment by the surety upon the beneficiary's demand. Hence the usual arguments like objections which the primary debtor could assert, the surety could do the same do not apply. The liability of the bank as surety could not go further than that of the primary debtor.

In practice, as could be seen from the specimen copies of bank guarantees, it is not unusual to have the following clause "payment on first demand, notwithstanding any contestion by the supplier or by ourselves or any other party" inserted in the guarantee. The purpose of this clause is to improve the attractiveness and value of the guarantee. Bank guarantees formulated in this way are in substance similar to cash deposit. Formerly cash deposits were required as security, but through the acceptance of banks' credit-worthiness, bank guarantees (with first or simple demand payment clause) now replace cash deposit. Hence the bank is authorised to make payments against the customer in favour of the beneficiary upon first demand. In the event that the exercise of the beneficiary's right is without foundation, the customer (principal) is compelled to institute a court action against the beneficiary for the return of the money. this would in most cases be in the beneficiary's country.

Art 9 RDUR provides that "unless the guarantee states the law which it is to be governed, the applicable law shall be that of the guarantor's place of business". (This in most cases would be the beneficiary's place of business).

It is to be emphasised that in the case of a beneficiary enforcing a right against a simple or first demand guarantee, the demand is made at the local bank in the local bank in the

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beneficiary's own country. This is the most vital purpose of a simple and first demand guarantee. As opposed to this, if the principal wants to sue the beneficiary against an unfounded claim, the former would have to file an action not in the principal's own country but in the country of the beneficiary. (This would cause a lot of inconvenience).

Another point of importance about bank guarantee whereby payment is expressed as upon simple or first demand is that in theory, is is as good as cash, especially if issued by a bank in the beneficiary's country.

From the beneficiary's point of view this is an excellent security as he has the utmost confidence in the creditworthiness of his local banker. Thus bank guarantees are indispensable and effective devices in the promotion of international trade.

23-6 Objections in case of non good faith exercise of rights under the guarantee

If the exercise of rights under the guarantee is obviously fraudulent, the bank is not required to pay. The same principle applies as in the case of confirmed letters of credit as exemplified by Sztejn v. J. Henry Schroder Banking Corporation.[67] The plaintiffs contracted to purchase bristles from Indian sellers. At the instruction of the plaintiffs, the defendants, an American bank, opened an irrevocable credit in favour of the sellers. The sellers presented, through the chartered Bank of India, a draft with apparently regular documents attached to it. But although the documents evidenced the shipment of bristles, the sellers actually shipped crates containing rubbish. On discovery by the buyers of this fraud, they brought an action for an injunction to restrain the defendants from accepting the draft which was upheld by the court.[68]

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67. 177 Misc. 719, 31 N.Y.S. 2d 631 (1941). See also E.P. Ellinger "The Tender of Fraudulent Document under Documentar Letters of Credit (1965) 7 Malaya L.R. 24.

68. Note Shientag J's reasoning at 31 N.Y.S. 2d at p.634. This rule in Sztejin was affirmed in Malas v. British Imex Industries Ltd. [1958] 2 Q.B. 127 per Seller L.J. at p.130.

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So it follows from Sztejin that in cases of deceitful or fraudulent demand by the beneficiary the bank need not pay. But the onus of proving fraud is on the bank.[69] In practice, in the interest of the bank's reputation, of its guarantees, they will be very reluctant to raise fraud to defeat a claim.

The injunction to prevent payment by the bank was successful in Sztejin but was not so in Malass v. British Imex Industries Ltd. [1958] 2 Q.B. 127 and also the recent decision of Discount Records v. Barclays Bank [1975] 1 W.L.R. 315.

In Malass, the plaintiff, a Jordanian firm, agreed to purchase two shipments of reinforced steel rods from the defendant. The Midland Bank opened two confirmed credits in favour of the defendant (seller). The latter sent the first shipment and realised the first confirmed credit. The plaintiff alleged that the goods were defective. They applied for an injunction to restrain the defendant from drawing on the second letter of credit.

The Court of Appeal refused to grant the required injunction. Jenkin, L.J., held that the confirmed credit was an absolute obligation of the bankers to pay "irrespective of any dispute there may be between the parties as to whether the goods are up to contract or not."[70]

Similarly in Discount Records v. Barclays Bank[71] an injunction was refused by the court. The plaintiff's evidence, Discount Records, was that on arrival the cartons containing the goods were found to be empty or half empty, or filled with rubbish, or containing mostly goods not ordered.

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69. For a detailed discussion of fraud in irrevocable credits see "Documentary Letters of Credit" by Prof. E.P. Ellinger published by the University of Singapore Press, 1970.

70. [1958] 2 Q.B. 127 at p.129. See also Davis O'Brien Lumber Co. Ltd. v. Bank of Montreal [1951] 3 D.L.R. 536 at p.550. Overseas Union Bank Ltd. v. Chua Teng Hwee (1964) 30 M.L.J. 165 at p.171 noted in (1964) 6 Malaya L.R. 417.

71. [1975] 1 W.L.R. 315.

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Per Megarry J.:

> "I see no need to keep the £4000 in any state of security, nor have adequate grounds been put before me for doing anything except leaving the plaintiff to their claim in contract.[72] I would be slow to interfere with bankers' irrevocable credits, and not least in sphere of international banking unless a sufficiently grave cause is shown, for interventions by the court that are too ready or too frequent might gravely impair the reliance which quite properly is placed on such credits..

Similar remarks were also made by Jenkin L.J. in Malass:

> "The system of financing these operations, as I see it, would break down completely if a dispute as between vendor and the purchaser was to have the effect of 'freezing' the sum in respect of which the letter of credit was opened." 73

The exception to the rule that in the absence of fraud, injunction is not possible could be illustrated by Elian v. Matsos [1966]2Lloyd's Report 495.

Shippers (Respondent) in Beirut shipped goods on a Greek ship which was chartered by Lebanese charterers. She was bound for R. The goods were consigned to buyers in Hungary. The ship was delayed at R and the shipowner (appellant) claimed a lien on the goods for demurrage.[74] Shipper wanted to release goods to buyer. Hence arranged with the Lebanese shippers to instruct their bankers in Lebanon, who in turn gave instructions to Midland Bank to issue a bank guarantee to

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72. The facts in this case are very akin to Sztejn yet the court distinguished Sztejn (1941) N.Y.S. 2d 631 on the basis that fraud was established in that case. Secondly the absence there of any possible holder in due course.

73. [1958] 2 Q.B. 127 at p.129. For similar decision in U.S.A. see Lamborn v. Lake Shore Banking & Trust Co. 196 App. Div. 504, 188 N.Y.S. 162 (1921), affirmed (no opinion) 231 N.Y. 616, 132 N.E. 911 (1921). Dulien Steel Products Inc. of Washington v. Bankers Trust Co. 189F. Supp 922 (1960), affirmed 298F. 2d 836 (1962).

74. This lien was good under the charterparty. The shippers were not liable to pay demurrage.

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the shipowners agent in London for lifting of the lien. The lien was lifted upon the giving of the guarantee. But at the same time he began to exercise another lien owing to further delay. Later the shipowners wanted to enforce the guarantee. The shipper applied to court for an injunction to restrain the shipowners or their agents claiming or receiving from the bank the money under the guarantee.

The Court of Appeal by an unanimous decision (Lord Denning M.R., Banckwerts and Winn L.JJ.) found for the shipper (respondent). Their Lordships held that this was a special case in which the court should grant an injunction to prevent what might be irretrievable injustice.

The point to emphasise about this case is that the shippers were not parties to the bank guarantee, nevertheless Lord Denning found that they have a most important interest in it.[75]

The Master of the Rolls agreed with counsel that a bank guarantee was very much like a letter of credit. The court would do their utmost to enforce it according to its terms. The crux of this decision is that despite what was held in Malass (i.e. the refusal of an injunction to restrain the bank from paying to the beneficiary by the application of the principal) that is not an absolute rule. There may be circumstances which warrant interference by injunction (even if the plaintiff is not a party to the guarantee).[76]

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75. Lord Denning then went on to say at p.497:
"If the Midland Bank Ltd., pay under this guarantee, they will claim against the Lebanese Bank, who in turn will claim against the shippers. The shippers will certainly be debited with the account. They will have to sue the shipowners for breach of their promise express or implied, to release the goods ... I know that the only lien they had in mind at that time was the lien for demurrage ... guarantee was given ... that lien was raised and no further lien imposed."

76. [1966] 2 Lloyd's Report 495 C.A. at p.497.

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The approach taken by the court is a pragmatic and revolutionary one, thereby it represents judicial innovation in relation to the granting of injunction in the area of letters of credit and bank guarantee.

The decision rests on premise of justice. This decision is undoubtedly inconsistent with Discount Records v. Barclays Bank.[77] An interesting feature to note is that Elian was not mentioned or argued at all before the court.[78] The decisions in Malass and Discount Records were policy decisions very much influenced by business efficacy. Hence very reluctant to intervene. The court in Elian was concerned with the consequences of not granting an injunction (i.e. the numerous court proceedings which could materialise as a result of one claiming reimbursement from another).

If one compares the approach taken by Lord Denning in Elian and Bache & Co. (London) Ltd. v. Banque Vernes et Commerciale de Paris S.A.[79], there is a difference in approach adopted by the same judge (seven years later). His Lordship found in favour of the beneficiary which was the reverse in Elian. The decision was based substantially on commercial practice and that public policy demanded that the conclusive evidence clause be given its full effect and vigour. It was immaterial that the principal would have to institute a court proceeding in a foreign country to recover the sum paid if it was erroneously made to the beneficiary.

Would Elian be decided in the same way again today. Judging from the change of Lord Denning's attitude in Bache & Co. (London) Ltd. and the recent decision of Discount Records, it is submitted that the court will be slow to intervene with international banking affairs.

23-7 Contract between bankers

Calico Printers' Assn. v. Barclays Bank [1931] All E.R.

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77. [1975] 1 W.L.R. 315.

78. What is the reason?

79. [1973] 2 Lloyd's Report p.437.

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350 C.A. Company was financed by Calico (plaintiff) in their business to ship goods to East. In order to protect themselves and maintain control of the bills of exchange which were sent forward for payment of goods, the bills of lading, and the goods to which they referred, they instructed Barclays Bank to receive and deal with the documents. Furthermore to undertake in some way or another to do something with reference to the goods when they arrived to limit their responsibilities in collection of documental bill for collection, the bank issued a form of request to be signed by person or firm delivering the bills for collection to them, subject to the condition that the collection was undertaken at depositors' risk only and that no liability whatsoever attached to the bank in connection therewith or with the storage and insurance of the relative goods. The bank employed subagent to collect the proceeds.

Held - in construing the exception clause, the court (i) must have regard to the document in its entirety and (ii) must consider what would be the liability of the bank if there were no clause exempting them from liability; in the present case the obligation of the bank in the absence of an exception clause would have been to use due care regarding the storage and insurance of the goods; the words used in the exemption clause were wide enough to cover negligence arising from failure to fulfil that obligation and, therefore the bank is not liable.

Indemnity

There are two types of indemnity given in relation to bank guarantee:

(1) Indemnity given by the customer of the bank (principal) to the bank either in the capacity as issuing banker or instructing banker.

(2) Indemnity given by the instructing banker to the intermediary banker.

(1) Indemnity given by customer of the bank

What is the surety's right to indemnity against principal

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debtor? Where the surety has undertaken his liability at the request, express or implied, of the debtor, this right to indemnity may arise in one of two ways:

(a) from an implied actual contract between surety and debtor;[81] or

(b) restitutionary remedy arising from the fact that the surety has been compelled by the law to discharge a debt for which the debtor is ultimately liable.[82]

Moulton L.J. in Re Richardson[83] emphasised the fundamental principle that the surety's right to an indemnity only arises on actual payment by him.

In Drager v. Allison[84] which concerned a case whereby the guarantor pays off the balance of a principal debt before due date, Cartwright J. decided the case as follows:

A surety who pays the guaranteed debt in relief of the principal debtor before the debt has become legally due and without any request from the debtor is not ipso facto converted into a mere volunteer. If no gift is intended, the paying surety does not forfeit his rights against the debtor but he cannot by prepaying before the due date accelerate his remedy. He can assert it ordinarily, only at the time when the guaranteed debt is payable. However, where the debtor definitely repudiates his obligation to the surety, the latter may sue for a declaration of his rights under the prepayment even though the guaranteed debt has not yet become payable. In the case of re Mitchell[85] a surety's equitable right to be indemnified by the principal debtor does not create any debt before the surety has been called on to pay anything under his guarantee.

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81. Re a Debtor [1937] Ch. 156 p.165.

82. Brook's Wharf v. Goodman BRothers [1937] 1 K.B. 534.

83. [1911] 2 K.B. 705, 712, 713.

84. (1959) 19 D.L.R. (2d) 431.

85. [1913] 1 Ch. 201.

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<u>What is the effect of the common law rule with regards to indemnity given to the bank by the customer?</u>

Specimen copy No. (1): "... to indemnify and hold you harmless and against any and all consequences ... and to reimburse you upon demand for any and all payments ..."

The words 'upon demand' would seem to imply that the surety could be indemnified at any time. This seems to conflict with the authorities mentioned above.

Specimen copy No. (2): "... to reimburse you on your first request for any sum ..."

Specimen copy Nos. (3), (4), (5) and (6) - no provision of 'first request' or 'upon demand'. In No. (7) clause 3 which provides that all money paid by the bank under the said bond may be debited and charged to any account or accounts of the customer with the bank without notice to the customer and without further authority than these presents.

No. (8) uses words like "to pay to you on your first demand by telex ..."

It is submitted that, phrases like 'upon demand', 'first request' or 'first demand' would not have much legal effect if the payment of debt is before due date by the surety or before the surety has been called on to pay anything under the guarantee.

<u>Law as to Limitation</u>

Specimen copy Nos. (3), (4) and (6) "... agree and undertake to indemnify you at all times ..." But the Limitation Act 1950 section 4 provides that no action could be brought after the expiration of six years from the date on which the cause of action accrued. S.4(a) deals with simple contract or on tort. S.4(d) - action to recover any sum recoverable by virtue of any enactment, other than a penalty or forfeiture or sum by way of penalty or forfeiture.

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An indemnity is a contract as it contains all the elements of a contract. Therefore would be within ambit of s.4(a). Alternatively, it could be within s.4(d). Hence the six year limitation period is applicable and it would override the provision of 'at all times" in the indemnity documents.

Extent of indemnity

In Sumner v. Powell[86] the Master of the Rolls [Sir Wm. Grant] puts forward the proposition that the extent of a person's liability under an indemnity depends on the nature and terms of the contract, and each case must be governed, in general by its own facts and circumstances. Thus if the obligation exists only by virtue of the covenants, its extent is to be measured only by the words of the covenant.

In Canada Steamship Lines Ltd. v. The King[87] It was held that if a clause conferring indemnity may extend to damage arising otherwise than by the negligence of the person indemnified or his servants, the clause would not be construed as extending to damage caused by such negligence, unless it was clearly expressed so to extend. The provision for indemnity against damages are embodied in specimen copies Nos. (1) (6) (7) and (8).

Following from Canada unless the indemnity form expressly states that damages arising from their negligence is covered, otherwise it would not be as illustrated by clause 17 in the Canada case. It provided that "the lessee shall at all times indemnify ... the lessor from and against all claims ... by whomsoever made ... in any manner based upon, occasioned by or attributable to the execution of these presents, or any action taken or thing done ... by virtue hereof, or the exercise in any manner of right arising hereunder."

Hence if the damages arise from the negligence of the banker then, the customer of the bank is not obliged to indemnify him against the damages following the decision of Canada in the absence of express provision for negligence. The phrase 'all consequences' is not broad enough to include

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86. (1816) 2 Mer. 30   87. [1952] A.C. 192 P.C.

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negligence.

In relation to cost, the holder of an indemnity, when acting within the scope of his authority, is generally entitled to recover against or compromise made by him in any legal proceedings in respect of any matter comprised by the indemnity, together with all cost properly incurred in defending such legal proceedings, including his own costs as between solicitor and client - Howard v. Lovegrove[88].

Buckley J. in Great Western Railway Co. v. Fisher[89] said:

> "I agree in thinking that a distinction is to be drawn between cases in which a person is entitled by contract to an indemnity and cases in which a person is simply recovering damages. If a person is entitled to an indemnity, there may be a right to solicitor and client cost; but where he is simply recovering damages he would not in general get solicitor and client costs."

In a recent New Zealand case of Mee v. DWD Hotels Ltd. and others (No. 2)[90] Whereby one person had agreed to indemnify another 'against all claims and actions and costs' it was held by Beattie J. that solicitor and client costs were recoverable.

Thus although specimen copies Nos. (1) (2) (5) (7) and (8) do not expressly provide that the costs or expenses would include legal costs as between solicitor and own client, nevertheless by relying on the abovementioned authorities this sort of cost would be covered.

Cost of proceedings

In all cases where there is a contract of indemnity the costs of legal proceedings properly incurred by the person indemnified are recoverable under the indemnity - Duffield v.

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88. (1870) L.R. 6 Exch. 43.

89. [1905] 1 Ch. 316, p.324.

90. [1974] 2 NZLR 272.

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Scott[91] Buller J. at p.630:

> "The purpose of giving notice is not in order to give a ground of action but if a demand is made, which the person indemnifying is bound to pay, and notice be given to him and he refuse to defend the action, in consequence of which the person to be indemnified is obliged to pay the demand, that is equivalent to a judgment, andestops the other party from saying that the defendant in the first action is not bound to pay the money."

In No. (1) the indemnity form expressly provides that the customer of the bank is to pay for the cost of the proceeding of any action commenced against the bank.

Would '<u>full liability for all consequences</u>' and '<u>incidental expenses</u>' be wide enough to include cost of proceedings in No. (2)? If an objective approach is taken it would include cost of proceedings as the two phrases are very broad in ambit.

Would '<u>all other liability of whatsoever nature or description ... incurred or suffered ... in connection with or in any manner arising out of the same guarantee</u>' in No. (3) cover cost of proceeding?

It is submitted that 'liability' will be wide enough to include cost of proceeding as this is a debit and therefore a liability in common parlance. Furthermore, 'of whatsoever nature or description ... in any manner arising' will reinforce the argument that it will come within the ambit of cost of proceeding.

Nos. (4) (6) and (7) expressly mention 'proceeding' hence it will include cost of proceeding.

No. (5) "<u>... any loss or expenses by reason of such payment or payments</u>'. Although this is not as comprehensive as the previous specimen copies, nevertheless it would be within the ambit of <u>Duffield</u> v. <u>Scott</u>[92] and therefore would get

91. (1789) 3 Term Rep. 374; 100 E.R. p.628.

92. (Supra)

indemnity for that (i.e. cost of proceedings) "... by reason of such payment" would indicate that the cost incurred is properly incurred.

Would 'loss or damage in all consequences resulting from issuing your guarantee waiving all rights of objection and defiance by a third party arising from said obligation.'

As to the loss or damages in all consequences resulting from issuing the guarantee waiving all right of obligation and defiance by third party suggests that no proceedings could be initiated, therefore it follows that cost of proceeding is not contemplated by the person who gives the indemnity and the recipient. Thus unless it is loss or damage resulting from <u>not</u> waiving all rights of objection and defiance by a third party arising from said obligation would cost of proceeding be indemnifiable as it would then be an incidental cost. If the cost is not recoverable it will be a loss and hence within the phrase 'loss or damage'.

<u>Payment</u>

Is a bank entitled to indemnity if payment is made on the guarantee by the bank not to the beneficiary but a third party (imposter of the beneficiary). This could arise where the third party has stolen the guarantee from the beneficiary. In this type of situation the banker (guarantor) is not obliged at all to make payment to the third party as the former is not obliged to make such payment at law. Hence words like 'all payments' in No. (1); 'all other liabilities of whatsoever nature or description' in Nos. (3) and (4) and 'liability' in Nos. (6) and (7). It is submitted that despite those prima facie very wide wordings used in the indemnity, the issuing banker is not protected where the issuing banker has made payment to the third party instead of the beneficiary. All payments must be construed as all payments being made by virtue of a legal duty to make those payments. But unfortunately the payment in the above situation could be construed as a loss. The reason being that the payment made to the third party could not be recovered as the crook would

have ~~been~~ vanished by then. Therefore it is a loss. The use of the phrase 'all consequences' in Nos. (1) and (2) proves to be good protection as it would cover all unexpected contingencies that could arise in relation to the guarantee. It is to be noted thatonly Nos. (1), (3), (4) and (5) use the word 'loss' which provides for adequate protection in the case where payment is made under a stolen guarantee. "Loss' is omitted in Nos. (6) and (7). If the argument on payment could be sustained then the bank may not be protected.

Last, but not least, payment to the third party could not be interpreted synonamously with claim, damage, or cost etc. as each of them carries a different meaning. Secondly the fact that they are inserted separately in the indemnity would further reinforce the argument that they are different in substance and nature to 'loss' or 'payment'. The ejusdem generis rule should not be used. In the stolen guarantee situations, contributory negligence could not be an effective defence as the guarantee is not under the control of the principal debtor but with the beneficiary.

<u>24-1 Indemnity between guarantor and 'surety'</u>

The case in which such a dispute arose was <u>British American Assurance Co. v. Redekopp</u>.[93]

The defendant (guarantor) guaranteed bonds issued by the plaintiff ('surety') for the due performance of a contract between T (the principal) and the Crown (beneficiary), for the construction of a school and other facilities at Sachigo Lake in Ontario. The contract was not finalised to the satisfaction of the beneficiary and the surety eventually took over the work from the hands of the principal. The surety sued to recover expenditure incurred to complete the obligation of the principal from the guarantor.

The issue of the case was whether the interior work had to be re-done.

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93. [1973] 6 W.W.R. 157.

The performance bond guaranteed that the principal would "well and faithfully observe and perform all the obligations of the said contract". The indemnity agreement on the other hand agreed "to indemnify the surety and save him harmless from all loss, damages, costs, charges, and expenses that it may sustain, incur, or be put to on account of any claim or claims under or in connection with, the said bond."[94]

A further clause in the indemnity agreement proceeded as follows:

> "I hereby jointly and severally further agree that vouchers or other evidences of payment made by the said company, under its obligations of suretyship, under the said bond ... shall be conclusive evidence against ME of the fact and extent of MY liability to the company, its successors and assigns ..."

His Honour said:

> "The words 'under its obligation of suretyship' clearly indicate the intention of the parties that the guarantee would be liable only for payments that the surety was obliged to make." 95

So following from the above reasoning, the obligation of the surety was not to take upon itself to determine the quality of workmanship or decide to do the work that would be satisfactory to the beneficiary.

The court further observed the fact that in obligations between principal and surety the law was one of guarantee and surety. These principles also apply to surety and guarantor.

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94. [1973] 6 W.W.R. 157 per Hamilton J. at p.162 - "... it still remains for the surety to establish that the principal did not perform his obligations under the contract and that it suffered loss as a result."

95. ibid at p.162.

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In the law of guarantee, reasonable conduct is required to bind a surety to its principal. Similarly surety must also conduct himself in a reasonable and responsible manner to obtain contribution from the guarantor.

Hamilton J. was of the opinion that the guarantor would be liable if the surety could establish that the work had to be done, that no more work than necessary was done, and that expenditure entailed was reasonable and proper.[96]

24-2 Indemnity - Action by contractor against surety (for subcontractor) for indemnity.

Dawson & Hall Ltd. v. United States Fidelity & Guaranty Company[97]

The respondent (contractor) secured a contract to renovate the old post office building in Vancouver. He sublet the painting to C (subcontractor). As required by the subcontract, the appellant furnished a suretybond to the contractor. Subcontractor became insolvent, the contractor terminated contract and called for tenders to complete the unfinished work. He paid the subcontractor's labour and material cost.

Objections were raised by the surety:

(1) That the bond did not guarantee payment of labour and materials accounts of the subcontractor. Further, the contractor should have required subcontractor to obtain a labour and material payment bond.

(2) That the sub-contract bonded did not refer to the terms of the prime contract between contractor and owner. Moreover prime contract was not established until after the subcontract had been made and the bond written. It was further contended that between subcontractor and contractor, the latter was not required to pay the former's labour and materials costs.

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96. Rees v. Berrington (1975) 2 Ves. Jun. 540, 30 E.R. 765 was applied.

97. (1963) 38 D.L.R. (2d) 53 (B.C.C.A.)

(3) That as between subcontractor, contractor, and surety, the contractor paid the labour and paint accounts voluntarily.

(4) That by paying the labour and paint accounts without surety's consent and over its objection, the respondent failed to maintain its rights under the subcontract, departed from its terms, and so discharged the bond.

(5) That the respondent without the knowledge of appellant, collaborated with the Department of Public Works and the General Paint Co. Ltd. to secure payment of the paint account at the expense of the surety, and so discharged the surety.

The first four grounds of the appeal were considered together. The majority held the view that the performance bond was one of indemnity.[98] Further judges in the majority held that clause 7 bound the subcontractor to conform to the conditions of the prime contract. Thus the subcontractor was bound as between himself and the contractor, to pay his own labour and paint, and the contractor was bound as between himself and the owner to see that the subcontractor did pay those accounts.[99]

Wilson J.A. dissented in part[1] taking a very narrow interpretation of the clauses in the guarantee. His Honour held that only that part of the prime contract dealing with labour had been incorporated into the subcontract. The performance of which was guaranteed by the surety. The part dealing with the supply of materials was not incorporated into the subcontract. Accordingly the surety, in the minority's view was liable for the subcontractor's failure to pay the labour accounts, but not the bills for materials. The majority (O'Halloran J.A., Davey J.A.) found for the contractor.[2]

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98. Regarding the measure of indemnity see (1963) 38 D.L.R. (2d) 53 at pp. 56, 57.

99. ibid. p.58.

1. ibid. p.60-62.

2. For a distinction between a performance bond and a labour and material payment bond see p.57 - per Davey J.A.

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Conclusion: The bank guarantee, like other guarantees, is not a contract uberrimae fidei, and does not therefore require full disclosure of all material facts to the surety.[3] On the other hand it also resembles letters of credit in the sense that intermediary bankers and documents for acceptances are involved in relation to claims by the beneficiary.[4]

Finally certain types of bank guarantee (as for example the performance guarantee) are very much like an indemnity. In fact Davey J.A. in Dawson & Hall Ltd. v. United States Fidelity & Guaranty Co. adopted the view that a performance bond is one of indemnity.[5] Hence the bank guarantee is a unique creature having characteristics of guarantee, letters of credit and of indemnity, which may therefore be referred to as 'tri nature document'. This tri nature characteristic of the bank guarantee must also influence its functions, which cover those performed by guarantee, letters of credit and indemnity, as illustrated by tender, performance, repayment and custom guarantees. A further point to note is that if RDUR is accepted, bank guarantees would be governed by those rules.

In the application of the laws of guarantee, letters of credit and indemnity, caution must be exercised as some of the general rules do not apply to bank guarantees. For example in the law of guarantees, despite some contradictory dicta in the cases.[6] The general approach seems to be that

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3. Hamilton v. Watson (1845) 12 Cl. & F. 109; Workington Harbour & Dock Board v. Trade Indemnity Company (1936) Vol. 54 Lloyd's Report p.103 H.L. But contrast with Bundy.

4. [1966] 2 Lloyd's Report p.495 at p.497 per Lord Denning "... I quite agree ... that a bank guarantee is very much like a letter of credit ...".

5. (1963) 38 D.L.R. (2d) p.53 at p.56.

6. See Rowlatt on Principal and surety 3rd ed. p.60 and Eshelby v. Federated European Bank [1932] 1 K.B. p.254 at p.266 per Swift J. "I do not see that a guarantor stands in any better position than any other contractor, and I do not see this contract is to be construed in any different way from any other contract."

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contracts of guarantees must be strictly construed in favour of the surety. Reasons for this strict construction are firstly that the surety generally receives no benefit from the contract which is, as far as he is concerned, gratuitous; and secondly, that in most cases these days, the contract is drafted by the creditor and, in accordance with the contra proferentem maxim, is accordingly to be construed in favour of the surety in case of doubt.[7] But as demonstrated in Harvell v. Foster[8] the above reasons are inapplicable; the court would not construe the contract so strictly. It is noted in Chitty on Contracts 2 ed. chapter 13 para. 1674 that the principle of strict construction does not prevent the court from looking beyond the terms of the written instrument. As in all cases of construction, the court is entitled to look at surrounding circumstances to ascertain the subject matter intended by the parties at the time the contract was made, and to determine the scope and object of the guarantee.[9]

In bank guarantees, an exception to the general rule of contra proferentem was applied in a recent decision of Thomas Fuller Construction Co. v. Continental Insurance Co.[10] Houlden J. is justified in favouring a broad interpretation of the bank guarantee, as the surety (bank) does receive benefit in monetary or other means, from the principal. It is not gratuitous at all. Secondly, as pointed out by His Honour, the bank guarantee is often drafted by the surety (assisted by professionals), hence it is justified that in any ambiguity in the bond, it should be construed against the surety.[11] Thirdly Harvell v. Foster lends support to the rule

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7. Eastern Counties Building Society v. Russell [1947] 1 All E.R. 500, 503; affirmed [1947] 2 All E.R. 734.

8. [1954] 2 Q.B. 367 C.A. ~~This~~ The solicitors were sureties for an administrative bond. Evershed M.R. adopted a wide interpretation in the construction of the bond based on the words 'well and truly administered the estate according to law'.

9. Heffield v. Meadows (1869) L.R. 4 C.P. 595; Leathley v. Spyer (1870) L.R. 5 C.P. 595; Nottingham Hide Co. v. Bottrill (1873) L.R. 8 C.P. 694.

10. [1973] 3 O.R. 202; 36 D.L.R. (3d) 336 at p.352.

11. ibid p.352 per Houlden J. "... The bond was prepared by the defendant and must be construed as against the bonding company ... plaintiff was given a discretion of determining when a default ... that notice need to be given ..."

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against contra proferentem.

With reference to the next point, on notice of default, this need not be given to the surety - Cutter v. Southern[12] and he is liable without being requested to pay[13] - in the absence of a stipulation to the contrary express or implied[14] or of circumstances rendering a demand upon him a legal obligation[15] RDUR - Art. 8 bis expressly provides for a notice of default by beneficiary to guarantor. But this appears to conflict with Thomas Fuller (supra) that a beneficiary is not bound to inform the surety of defaults by principal unless the surety agreement so provides (consistent with law of guarantee). Which is to prevail?

A simple or first demand bank guarantee is unique, as there is no parallel in the law of guarantee[16] and this type of bank guarantee is exclusively governed by RDUR.

Yet another distinguishing feature of bank guarantee from other guarantees is that the beneficiary's right to payment under the guarantee is dependent on whether it is a three or four party guarantee.

The law relating to letters of credit is required to supplement the inadequacies in the law of guarantee, to handle questions of fraudulent demand, forgery, reimbursement by principal to beneficiary and other matters which are concerned with the dealings of the documents among the three parties (principal, surety and beneficiary).

A novelty created by Lord Denning in Elian[17] is that a third

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12. (1667), 1 Saund 116; 85 E.R. 123.
13. Hitchcock v. Humfrey (1843); 5 Man C.G.559; 134 E.R. 683.
14. Brown v. Brown [1893] 2 Ch. 300 and Morten v. Marshall (1863) 2 H. & C. 305; 159 E.R. 127 respectively.
15. Payne v. Ives (1823) 3 DOW & Ry.K.B. 644.
16. The closest is an 'on demand' guarantee in Brown v. Brown [1893] 2 Ch. 300.
17. [1966] 2 Lloyd's Report 495.

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party having an interest in a bank guarantee could seek an injunction from the court to halt payment by the bank (surety) to the beneficiary on the basis of justice. But this decision is not consistent with Malass and Discount Records (supra).

In Canada, there is now a new development in the law concerning subrogation. The court has refused to allow an extension of the subrogation principle, so as to enable the surety to pursue by way of subrogation, rights accruing to the beneficiary against a third party based on default and not covered by the guarantee on which the surety paid. This was so even though the default of the third party could have contributed to the failure of the principal. The court in Prince Albert[18] was slow and reluctant to allow a novel claim as contrasted with the court of Appeal in Elian.

Ultimately in the field of indemnity between guarantor and surety, the law of guarantee also applies in equal force.[19]

At the moment, the latest trend in judicial approach towards bank guarantee is a reluctance by courts to intervene in international banking affairs.[20] There are advantages and disadvantages in adopting this approach. The former is not to disturb commercial practice and hence reduce the confidence of businessmen. The latter is that injustice could result requiring expensive, cumbersome, time-consuming andcostly litigation to recover an amount paid under an unjustifiable demand by the beneficiary.

The RDUR does to a certain degree help to resolve some problems relating to bank guarantee. But it is not comprehensive enough to provide remedies similar to those at common law, and thus tends rather only to supplement some of the deficiencies in the law governing bank guarantee.

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18. Prince Albert v. Underwood McLellan & Associates Ltd. (1967), 61 W.W.R. 577.

19. Redekopp [1973] 6 W.W.R. 157.

20. Bache & Co. Ltd. [1973] 2 Lloyd's Report p.437.

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