

BONDS-GUARANTEES FOR EXPORT CONTRACTS

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1. Introduction.

The provision of a bond or a bank guarantee represents a device, which provides the customer with a security in case a specified undertaking contained in a contract between supplier and customer is not adequately fulfilled.

The establishment of such sureties in the form of bonds or bank guarantees has become accepted practice in export markets and presents the supplier frequently with problems which are not normally considered until an offer is ready for submission or a contract with an overseas customer ready for signing.

2. Definitions and technicalities.

For the purpose of this guide-line the meaning of the terms guarantee and bond are identical. A bond is a written guarantee given by one party to another for the fulfilment of certain contractual obligations undertaken by a third party.

There are normally three parties involved:

- a) The party who requests the guarantee and to whom it is given - the buyer or the customer.
- b) The party primarily responsible for the performance of the contract - the exporter or the supplier.
- c) The party who gives the guarantee or bond - the guarantor (surety) or bank or insurance company.

The following are the principle types of guarantee/bonds:

2.1 Tender guarantee/bond

A written guarantee given to a customer by a bank or insurance company to cover the customer's expenses in the event of a supplier failing to enter into a contract if requested by the customer.

2.2 Repayment guarantee/bond

A written guarantee given to a customer by a bank or insurance company to repay advance or progress payments made in advance of completion of the contract in the event of the supplier not fulfilling the terms of a specific contract.

2.3 Performance guarantee/bond

A written guarantee given to a customer by a bank or insurance company against a supplier's unsatisfactory performance of a specific contract in accordance with all its terms and conditions.

2.4 Warranty guarantee/bond

A written guarantee given to a customer by a bank or insurance company against a supplier not standing by his warranty undertaking as specified in the contract.

2.5 Release or retention guarantee/bond

A written guarantee to project the customer once he agrees to release retention money before it is contractually due for release.

2.6 Bond categories

Bonds fall into two categories both of which apply to all the definitions mentioned above:

- a) Bonds which place the onus on the customer to prove the default of the supplier and which generally only provide for payment up to extent of the customer's actual loss.
- b) Bonds which are payable "on demand" at any time and often for their full amount irrespective of the extent of customer's loss. Such bonds can therefore be called whether or not the supplier has fulfilled his contractual obligations. Bonds which are payable on receipt of a mere letter from the buyer or perhaps from the consulting engineer, alleging default, are considered to fall into this category. Once the payment has been made under the bond, the onus is then on the supplier to prove that he was not in default and to recover any money due to him from the customer.

2.7 Who issues bonds

There are normally two sources of bonds:

- a) Banks, who are the traditional source and
- b) Insurance companies, including the specialist surety companies.

a) The bank bond

Banks generally regard the insolvency of their customer as the principal risk to cover and view bonds as part of the overall credit facilities extended to their customers so that bank bonds can restrict overdraft facilities and future borrowing powers. Similarly a limit on overdraft facilities may at any time prevent the issue of a bond. Furthermore banks consider that their role precludes them from becoming involved in disputes between their customers and third parties and, would not regard themselves as competent to do so. Their international reputation depends on their paying money promptly and without demur.

For these reasons banks prefer to issue "on demand" bonds, which impose very onerous liabilities on the supplier, because the bank will pay the customer when "he demands" it.

b) The insurance or surety companies bond

Bonds issued by insurance or surety companies are related to the supplier's financial capacity and his standing and expertise in the particular business, they do not directly impinge on the supplier's overdraft limits and are potentially therefore an alternative source of credit.

The insurance or surety company before a bond will satisfy itself that the supplier can and will perform the contract or, if he defaults, can himself pay the amount of the bond. The surety has regard to the following:

- a) The expertise and experience of the supplier in the type of work, size of contract, country involve etc.
- b) The ability of the supplier to fulfil the light of his total work load.
- c) The contract conditions.
- d) The financial standing and worth of the supplier.

Insurance companies generally insist on examining the conditions of any contract which they are being asked to bond and their experience in this field, together with their considerable knowledge of the territory involved, can be of great benefit to the

supplier and have often in the past prevented the unwitting acceptance of unduly onerous contract conditions.

Surety companies prefer to issue "default" bonds wherever possible requiring the customer to prove his loss. They will join the supplier to fight unjust claims and take action to minimise loss.

Because they are writing on an unsecured basis and because of the different underwriting approach, the criteria set by surety companies can be more difficult than those of the bank.

The surety company should, in the case of difficulties arising be prepared to assist towards the satisfactory completion of the contract by providing technical or financial support to the original supplier.

3. How to proceed.

Study the customer's requirements, establish the various commercial risks involved and examine the terms applicable to any tender and/or contract with particular reference to those areas which are likely to require the establishment of guarantees and bonds.

- 3.1 Examine the customer's requirements as to the type of guarantee/bond which he required for the various areas of the project and then examine which form of guarantee is likely to meet his requirements.
- 3.2 Where the customer is well known to you and a particularly good relationship exists you may try to discuss with him as to whether he would be satisfied with a "Letter of Guarantee" issued by your company. This type of guarantee although the most desirable from the point of view of the supplier is not normally acceptable in overseas transactions.
- 3.3 Examine the possibility as to whether the customer would accept a guarantee issued by a bank which becomes effective whenever supplier and customer agree that the supplier is in default and the extent thereof or whenever the customer and supplier have gone to arbitration certificate has been issued against which the bank will make the required payment.
There will be few overseas transactions (customers) to whom this type of guarantee is acceptable.
- 3.4 The advantage to the supplier of meeting the customer's "guarantee" requirements with an insurance bond are obvious. Such bonds are normally issued by ready companies (usually subsidiaries of insurance companies). These bonds are very specific, extremely difficult to negotiate and limited to the cover of clearly prescribed and specified risks. The provision of such bonds involves normally major negotiations, full examination of the supplier's balance sheets etc. This type of bond

is, however, only acceptable in fairly rare cases and it is worth noting that in some territories customers are not sufficiently familiar with the status of Surety Companies so as to make them readily acceptable. Generally these bonds take the form of "default" bonds requiring the customer to prove his loss.

- 3.5 Most guaranteed requirements involve the issue of "on demand" bank guarantees. Such guarantees usually take the form of a bond issued by the supplier's bank. This type of bond covers the vast majority of all overseas requirements. This type of guarantee should be so arranged that it only comes on risk once customer has fulfilled all requirements to bring the contract in full force and effect.

Whether such a bond is given by a bank or an insurance company, the calling of that bond results sooner or later in a corresponding call on the supplier. It is, however, most important to remember that the recourse under a bond payable "on demand" is absolute and immediate.; Therefore a supplier who gives such bonds - almost universally required in the Middle East - is open to:

- a) The risk of the bond being called for political or spurious reasons and
- b) A potentially distressing stain on liquidity as the results of the immediate recourse, possibly at a time when the supplier is least prepared for it.

- 3.6 Thus, where an on demand bank guarantee is provided, the supplier is open to the following hazards:

- a) The customer can threaten to claim unless the supplier agrees to extend the guarantee. This is of particular relevance where an on demand bid guarantee is required for a fixed price tender.
- b) The supplier has to comply with local statutes governing bank guarantees and some of these allow a claim to be made notwithstanding the fact that the validity date of the guarantee has expired.
- c) The international reputation of a bank is largely dependent upon it honouring guarantees promptly and without demur, and thus it will almost always accept the required statements or other evidence without having responsibility for the truth or accuracy of these statements.
- d) The supplier can be exposed to additional costs (i.e. local duties, (fees) when posting such guarantees and should investigate these and the cost of extending the guarantee before committing himself.