CAN U.S. BANKS ISSUE GUARANTEES?

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by Vincent Maulella*

In answer to the often-asked question "Can US banks issue guarantees?", most readers have probably heard the response: "No, except for Morgan Guaranty because they are grandfathered." For decades, bankers around the world simply repeated that response as if it were a mantra without much thought given to what it meant. Even though the statement was not 100% correct, it sounded authoritative and everyone accepted it.

In fact, the creation and growth of the standby market in the United States and globally has been attributed in some circles to a perceived US regulatory prohibition against the issuance of guarantees or anything with the word "guarantee" in it. Today the response needs to be revisited. Over the years, the market has become more sophisticated, participants more articulate, and, to the delight of all, regulators and rule-makers have largely acted in concert with the market.

What's in a Name?

To US bankers, the word "guarantee" suggests something foreign banks do; surety is something US insurance companies do. "US banks do not and cannot guarantee someone else's performance!" "The bank is not a party to the underlying transaction and therefore cannot determine if there has been contractual compliance!" "Banks are not empowered or permitted by their charter to do this!" How many times have you heard these arguments?

Historically, US courts have restrictively interpreted statutory provisions empowering banks to engage in banking activities: if a power was not expressly granted, it was not given. As the result of a series of 19th century cases, suretyship activities of banks were determined to be *ultra vires*. Compound that with the conservative bias of bank counsel and these interpretations went unchallenged; they simply became accepted as a limitation on bank powers.

However, with the growth of standbys in the 1970s, it became imperative for regulators to determine whether a bank was authorized to engage in any activity that resembled a traditional suretyship undertaking. Standbys were seen as functionally similar to suretyship undertakings with which they competed for market share.[1]

Suretyship v. Standbys

So, what was the regulators' rationale for their decision? To start with, the issue had long been settled for commercial letters of credit. Perhaps that made the process easier. Do standbys more closely resemble commercial LCs or suretyship undertakings and guarantees? Given that *DCI*'s readership understands commercial letters of credit, let's consider how suretyship undertakings and accessory guarantees differ from standby letters of credit.

In a suretyship undertaking or accessory guarantee, the issuer is obligated to pay or fulfil another's obligation; defences available to the principal are generally available to the guarantor.

As a general rule, the guarantor's obligation is linked to the underlying transaction and only arises if

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1. Professor James E. Byrne, *An Introduction to the Revision of §7.1016: Letters of Credit and other Independent Undertakings*, (IIBLP, 1996).

and to the extent that obligation is due, often necessitating intense factual inquiry. Henry Harfield[2] observed that one of the primary elements distinguishing a surety from a banker issuing a standby letter of credit is the question of what types of risk are being evaluated. The banker examines the credit-worthiness of its customer, while the surety focuses on the statistical probability of certain events occurring which would prevent his principal from performing the contract.

Granted, these risks may overlap. Harfield concedes that a surety may disregard his principal's ability to perform a commitment if he is satisfied that the principal's financial condition is such that the principal can reimburse the surety for money demanded or for funds needed to complete the project, if that is the undertaking of the guarantee.

Accordingly, it is not unusual to see standby letters of credit issued in favour of surety companies, although one must wonder if the costs for both undertakings are economical.

In a letter of credit, the bank is guaranteeing its own performance, i.e., the bank will pay (honour) upon presentation of a complying document, and that document may state that there has been a default. So, the bank does not determine that a default occurred but merely determines whether it received a required document stating that a default occurred. That reasoning leads to the logical use of the letter of credit as a substitute.

Text v. Title

The 1962 Revision of the *Uniform Customs and Practice for Documentary Credits* (UCP), ICC Publication No. 222, first introduced the expression "any arrangement, however named or described" to encompass all undertakings which might be covered under the generic "documentary credit(s)"and "credit(s)". That same expression was used in the 1974, 1983, and 1993 Revisions of UCP. The 1983 and 1993 revisions expanded the stated litany to include "standby letters of credit".

ICC uses the same "however named or described" expression in the *Uniform Rules for Demand Guarantees* (ICC Publication No. 458) to identify undertakings such as guarantees, bonds, and the like which may be included under those rules.

On the US domestic scene, the revision of the US Uniform Commercial Code (UCC) Article 5, simply defines letter of credit as "a definite undertaking". Importantly, Comment 6 to Section 5-102(10), reinforces the idea that "The label on a document is not conclusive; certain documents labeled 'guarantee' in accordance with European (and occasionally, American) practices are letters of credit."

To reinforce the point that labels are no longer the critical determinant, the 1996 Interpretive Ruling of the US Office of the Comptroller of the Currency dropped its 25-year old safety and soundness guideline stating that "Each letter of credit should conspicuously state that it is a letter of credit or be conspicuously entitled as such." The ruling itself uses the expression "letters of credit and other independent undertakings" and the OCC discussion accompanying the Federal Register notice explains that this change updates the former regulation "to reflect modern market standards and industry usage, and to cover a broader array of transactions in this area".

In the international arena, UNCITRAL has drawn up a convention entitled the UN Convention on Independent Guarantees and Stand-by Letters of Credit. The title alone strongly suggests that these two types of instruments may perform the same functions. Article 2 of the convention defines "undertaking" as an independent commitment to pay upon simple demand or upon demand accompanied by other documents, in conformity with the terms and documentary conditions of the undertaking.

Finally, the most comprehensive effort to date articulating rules of practice for this class of undertakings, the *International Standby Practices 1998* (ISP98) (ICC Publication No. 590), states that

2. Henry Harfield, *Bank Credits and Acceptances* (5th Edition, 1974).

the rules simply apply to "A standby letter of credit or other similar undertaking, however named or described ... ". The Preface to ISP98 suggests other standby names, reflecting the market characterization of standbys according to their use in the underlying transactions. Therefore, undertakings titled "Bid Bond", "Tender Bond", "Advance Payment Guarantee", "Counter Guarantee", "Insurance Standby", and "Performance Guarantee" may well fall under the rubric of standby letters of credit, provided the undertaking is independent and documentary.

Independent and Documentary?

How do we determine whether an undertaking is independent and documentary? Clearly, the independent character of the undertaking should be apparent from its terms. That reference may be explicit, or alternatively, the undertaking itself should "subject it to laws or rules providing for its independent character".[3] Accepting this "safety and soundness" guideline from the Office of the Comptroller of the Currency, undertakings issued subject to the UN Convention, UCP, Uniform Rules on Demand Guarantees (URDG), Revised UCC, or the ISP are independent.

The Various Models

Let's look at each of these models. The UN Convention frames this independence as separate from the precedent (underlying) transaction or the subsequent (counter-guarantee) transaction. It also enhances our appreciation of the independent undertaking as something that may be within the control or sphere of operations of the issuer.

Using UCP terminology, "independent" means that the undertaking is separate from the underlying "sales or other contract(s) on which they may be based". UCP 500 Article 3 further refines the independent nature of the under-taking, reinforcing that separateness, "even if any reference whatsoever to such contract(s) is included in the Credit". UCP 500 Article 3 clearly expresses the point that the issuer cannot avail itself of defences otherwise available to the applicant "resulting from his relationships with the Issuing Bank or Beneficiary". Conversely, the beneficiary cannot avail itself of "the contractual relationships existing between the Applicant and the Issuing Bank".

These explicit references to defined relationships underscore the separateness of the undertakings: (i) the underlying sales or other contract; (ii) the application and security agreement; and (iii) the letter of credit. The first, the underlying sales contract that specifies that payment is to be made via letter of credit, is between the buyer (applicant) and seller (beneficiary). The bank (issuer) is not a party to that contract. The second, the application and security agreement between the buyer and the bank, requests the bank to issue the letter of credit, but the seller (beneficiary) is not a party to that arrangement. Finally, the actual letter of credit in which the bank obligates itself to pay the seller (beneficiary) against the presentation of documents is a unilateral bank obligation to the beneficiary. The applicant is not a party to the credit.

This clearly distinguishes the letter of credit, however named or described, from a contract guarantee, accessory guarantee or other bilateral contract that would effectively make the bank a party to the underlying transaction and make the bank's obligation dependent on the underlying arrangement to which it is not a party.

URDG Article 2(b) parallels UCP Article 3: "Guarantees by their nature are separate transactions from the contract or tender conditions on which they may be based and Guarantors are in no way concerned with or bound by such contract(s), or tender conditions, despite the inclusion of a reference to them in the Guarantee."

This principle is restated with greater specificity in the UCC, the UN Convention, US regulatory guidelines, and in expressions of market practice. In each of these articulations, "independence" is expressed in terms consistent with the focus of that

3. *Office of the Comptroller of the Currency Interpretive Rulings, 12 C.F.R. §7.1016(b)(1)(i).*

particular set of rules.

For example, in the UCC the focus is on the legal implications of the independence principle, that is, the rights and obligations of the parties - notably the issuer and beneficiary - and the impact of that relationship on injunctive relief. The Commentary to UCC Section 5-109, "Fraud and Forgery", gives additional insight. It justifies the setting of a high standard for injunctive relief, in part due to the independence principle: only where "the contract and circumstances reveal that the beneficiary's demand for payment has 'absolutely no basis in fact' [and] where the beneficiary's conduct has 'so vitiated the entire transaction that the legitimate purposes of the independence of the issuer's obligation would no longer be served,'" may a court enjoin payment.

ISP98 Rule 1.06(c) restates the independence principle and offers insight into its practical application: "Because a standby is independent, the enforceability of an issuer's obligations under a standby does not depend on:

i. the issuer's right or ability to obtain reimbursement from the applicant;

ii. the beneficiary's right to obtain payment from the applicant;

iii. a reference in the standby to any reimbursement agreement or underlying transaction; or

iv. the issuer's knowledge of performance or breach of any reimbursement agreement or underlying transaction."

Additionally, ISP98 Rule 1.07 provides: "An issuer's obligations toward the beneficiary are not affected by the issuer's rights and obligations toward the applicant under any applicable agreement, practice, or law."

The Devil is in the Details!

"Documentary" means that the bank's decision to honour is based on a determination as to whether the required document was presented, not whether the event actually occurred. UCP 500 Article 4 states that in "credit operations, banks deal in documents, not in goods, services or other performances to which they may relate." UCP further states that banks are not responsible for the "form, genuineness, sufficiency, of the documents ... ". In addition, sprinkled throughout UCP is the requirement for presentation of "specified documents". Finally, non-documentary conditions and documents not called for in the credit are to be disregarded.

Consistent with UCP, Revised UCC Article 5 bases the validity, operation, and enforceability of the undertaking on the presentation of documents. So central is the presentation of required documents to the letter of credit that, in addition to the admonitions in the 5-102 Commentary, the 5-108 Commentary states explicitly that: "Where the non-documentary conditions are central and fundamental to the issuer's obligation (as for example a condition that would require the issuer to determine in fact whether the beneficiary had performed the underlying contract or whether the applicant had defaulted) their inclusion may remove the undertaking from the scope of Article 5 entirely."

In the OCC's safety and soundness guidelines, the bank is not to determine "a matter of fact or law at issue between the applicant and beneficiary". Under such letters of credit or other independent undertakings, the bank's obligation to honour depends upon the presentation of specified documents and not upon non-documentary conditions or resolution of questions of fact or law at issue between the account party and the beneficiary.

The ISP simply states that the documentary nature of the standby "depends on the presentation of documents and an examination of required documents on their face".

These two defining principles of this idiosyncratic form of engagement are clearly enunciated and repeated in UCP, UCC, UN Convention, the OCC Regulations and now the ISP.

The easiest way to ensure that the subject undertaking meets these requirements is to make the bank's undertaking subject to a set of rules which incorporate these principles.

Cautions

There are other nuances of these new rules and regulations that recognize and give validity to relevant market practice. Based on the rule-making body, there are obvious biases.

For example, the UCC legislates formalities, rights, responsibilities, and remedies; the Comptroller's promulgation focuses on the management of risk; while ISP98 reflects the better practice of the better practitioners. Collectively, all of these instruments allow issuers to intelligently and selectively respond to market demands for flexible undertakings within certain parameters.

However, while the standby has one of the more creative and innovative sides of banking, there have been certain grounds upon which even the most courageous standby practitioners have been careful to tread lightly. Obligations without stated expiry dates, amounts payable based on fluctuations in public indices, and undertakings conditioned on actions involving the bank itself have always presented unique challenges for the banker trying to accommodate a customer and to satisfy a market need while not violating any regulation or law. Still, bankers willing to research the rules and do their homework can find support and direction for issuing standbys or guarantees (however named or described) without expiry dates, whether payable in dollars, dinars, or in any other currency, documents or other items of value. For those willing to push the envelope further, the amount available may even fluctuate, based on market changes, such as LIBOR or PLATTS. The availability of the obligation itself may be conditioned on the determination of events, such as the receipt or sending of funds or similar operations that can be determined to be within the bank's "sphere of control".

Conclusion

Ask that same question today: "Can US banks issue guarantees?" and you will receive a different answer, e.g., "What is a guarantee?", "Can you define guarantee?" If you define guarantee as an independent undertaking to pay against documents, then the evolution of decisions and interpretations by regulators and lawmakers should now lead us to answer: "Yes, US banks can and do issue guarantees!"