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Supreme Court rules on lost and returned guarantees

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April 01 2011

Loss of original guarantee
Returned guarantee

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The Supreme Court recently dealt with two incidents that may easily occur in the course of handling bank guarantees.

Loss of original guarantee

In the first case the beneficiary had lost the original guarantee and could present only a copy when demanding payment under the guarantee. It could not be ascertained how the original guarantee had disappeared - it had probably been lost in the mail with a previous demand.

The bank refused to honour the guarantee because the guarantee terms stipulated that in order to make a valid demand, the original guarantee had to be presented. The lower courts applied the principle of 'strict formality' that prevails in the interpretation of bank guarantees - namely, that all of the conditions set forth in the guarantee for making a demand must be fulfilled. Thus, the bank rightly refused to pay.

Although the Supreme Court softened its application of the principle of strict formality, stating that it does not constitute an end in itself, but has effect only insofar as it reflects the intention of the parties, it affirmed the lower courts' decisions. The court argued that the principle does not hold if the fulfilment of the conditions is beyond the sphere of the beneficiary (eg, if the course of events takes an unprecedented turn or the beneficiary is not in control of the contents of the documents to be presented). In the present case it was undisputed that the beneficiary had been in possession of the original guarantee, and that the loss had occurred within her sphere. The court also held that by honouring a formally invalid demand, the bank would risk the reimbursement of its client on whose account the guarantee was issued. Moreover, it could not be ruled out that a new demand would be made if the original guarantee surfaced before its expiry date, as the circumstances of the loss were unknown.

While the argument with regard to legal certainty in relation to the client is understandable, the other about the repeated demands is not. A bank guarantee is not a bearer instrument in the sense that any holder may exercise the rights thereunder. Thus, a bank can easily refuse to honour a repeated demand if the guarantee has already been drawn. Full transfers or assignments of guarantees (ie, the right to make drawings) are normally not permitted, so the risk of a valid demand being made by a party other than the original beneficiary hardly exists. Furthermore, it could be argued that reasonable parties, taking account of the possibility of losing the guarantee, would agree on a mechanism whereby the presentation of a copy should suffice. However, the court did not follow these arguments and insisted on the presentation of the original guarantee.

Thus, the question arises as to the remedies that are open to a beneficiary that requires the original guarantee, but has lost it. The present decision does not leave many options open. One possible remedy would be to have the lost document declared ineffective by the court. Normally, only securities in the technical sense (eg, bonds, stock certificates, savings books and bills of exchange) may be declared ineffective under the relevant act. Bank guarantees normally do not fall thereunder, as they are evidence of a right, but are not constitutive of it. However, if a bank guarantee must be presented in the original in order to constitute a valid demand, it should qualify for a declaration of ineffectiveness under the relevant act, as its importance comes close to that of a bearer instrument. The consequence of such a declaration is that the court order declaring it ineffective replaces the original, so that a valid demand could be made. The drawback is that the procedure for such a declaration takes at least six months, so it is unlikely that a court order will be obtained before the guarantee expires.

Normally, the beneficiary will not discover the loss of the document until very close to the expiry date.

Thus, there are only two practical remedies:

- not to accept bank guarantees that need to be presented in the original (which also helps to avoid the problem of not having the original at hand in case of multiple drawings when it is uncertain whether, after the first drawing, the original will be returned in time for the next drawing, if at all); or
- to keep the original in very safe custody.

Returned guarantee

The second decision concerned a bank guarantee that had been issued to another bank as beneficiary in the context of a real estate transaction to secure the financing of the purchase price. The trustee who was mandated to execute the transaction returned the guarantee to the issuing bank on the grounds that the intended transaction could not be completed as planned. The bank then selected another trustee and sent the same guarantee to him. The bank did not fully inform its client on whose account the guarantee was issued about the reasons for the change, and stated that the first trustee had to be replaced because his bank account could possibly be attached by other creditors.

The bank guarantee was eventually drawn and the bank's client sued the issuing bank for damages, arguing that had the bank informed him about the true reasons for the change of trustee, he would have revoked the bank guarantee and not suffered the damage caused by the drawing of the guarantee.

The claim was admitted by both of the lower courts and the Supreme Court. The Supreme Court held that normally the bank issuing a bank guarantee is under no duty to warn or explain to its client the risks connected with a bank guarantee, since it is a common form of security and the bank may assume that its client and the beneficiary have sufficient knowledge of its function. However, if the bank acquires relevant information suggesting that the transaction which is secured by the bank guarantee is not feasible or cannot be performed as envisaged, it is under a duty to inform its client accordingly. Failure to do so renders the bank liable for damages.

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