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GUARANTEES AND SECURITIES

Note by the Secretary-General

Addendum

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II. TEXT OF OBSERVATIONS BY MEMBERS OF THE COMMISSION

HUNGARY

[Original: English]
30 January 1970

A. Guarantees

I

For our part we are in full agreement with the Report* in so far as it uses the term "guarantee" as the notion of a guarantee of payments in the most general and widest sense (chapter I.4). In this way the possibility has been opened for the extension of studies and investigations to a wide scope. The Report achieves its object by reviewing a large number of forms of guarantees known and current in international commerce; in addition, the Report, in the section on the nature of guarantees (II, A.1.) analyses what, in our opinion, is the most significant problem, viz. the differences under the various national laws between a suretyship and a guarantee, a banker's collateral security and a banker's guarantee. As far as Hungary is concerned, the Hungarian delegation emphasized the significance of the problem at the second session of UNCITRAL in Geneva, and at the same time put forward recommendations in the matter of a bank guarantee.

II

Although guarantees are employed in an expanding world economy, statutory regulation can be found in the legislation of only a limited number of countries. Even here, regulation is restricted to rather tersely worded provisions.

Of the statutory regulation of guarantees, mention may be made of article 111 of the Swiss Obligationenrecht. Under this provision when anybody undertakes a liability to a person for the performance of a third party, in case of default in performance the person undertaking the liability will be liable to consequential damages.

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* A/CN.9/20 and Add.1.

Article 138 of the Italian Codice Civile on guarantee contracts provides that anybody undertaking an obligation to the effect that a third person will enter into some sort of an obligation, or perform something, shall be bound to indemnify the other contracting party in the event the third person repudiates the undertaking of a liability or fails to make performance.

Reference should also be made to section 124 of the Indian Contract Act, 1872 (No. IX of 1872), consolidating the rules of primarily unwritten English law, according to which under a contract of indemnity, the one party undertakes the reparation of the loss caused to the other party by either himself or a third person.

These provisions of statute law, although beyond doubt conforming to the most widely understood notion of a guarantee, are no more applicable to the bank guarantee as well known in modern business life, than article 248 of the Hungarian Civil Code.

Thus, the contract of indemnity under Indian law is close to a liability insurance. In particular in a bank guarantee the banker does not commit himself as to his own attitude. In all three regulations on grounds of economy in a bank guarantee - although a legally autonomous undertaking - so essential third person, i.e. the client who refunds the sum called up under the guarantee, or undertakes the payment of the banker's commission, is missing. In these regulations this third person is relegated to the background. He must not necessarily be acquainted with the guarantee given or undertaken on his behalf; moreover, such a person must not even necessarily exist.

The most recent relevant regulation is taken up in the Czechoslovak Foreign Trade Code. According to article 665 of the Code, under a bank guarantee the bank (banking institution) undertakes to give satisfaction to the receiver of the guarantee (the obligee) in accordance with the contract of the guarantee if the third party defined by the contract shall fail to meet his obligation, or if the conditions specified in the guarantee shall be fulfilled. According to the Report (note 11 on p. 5), this definition agrees with the notion of both a guarantee and a contract of indemnity. Since the Report quotes the Czechoslovak Foreign Trade Code as an exception from the rules that commercial legislation does not bring under regulation the bank guarantee, it appears as if the Report

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partly identified the bank guarantee with a contract of indemnity, partly considered the first part of article 665 of the Czechoslovak Code a suretyship and the second the guarantee proper. We are unable to conform to this opinion. As we see the it, the first and second parts of the facts in question stand in a relation to each other of the acceptation of the terms in the narrower and wider senses, still in no case as definitions of two different legal institutions.

On the other hand, the Report fails to refer to article 672 of the Czechoslovak Code, according to which a bank guarantee includes the obligation of the bank to discharge the guaranteed obligation at the first notice of the obligee without putting in a plea to which otherwise the client as debtor would be entitled to the obligee under the obligation reinforced by a guarantee. If this provision is applied either part of the definition of article 665 would as for its content change over from a suretyship to a guarantee. Hence the statement may be ventured that the Czechoslovak Foreign Trade Code brings under regulation the bank guarantee not as an autonomous institution of law bearing a specific designation, but merely as a sub-species of a banker's collateral security.

Reverting to the circumstance that the Report identifies the bank guarantee with the contract of indemnity, we should like to remark that in the Czechoslovak Code it is the promise of indemnity (declaration of indemnity) rather than a bank guarantee that corresponds to the contract of indemnity. Under a promise of indemnity the declarant undertakes to make good to the acceptor of the promise or the promisee any loss arising from the transaction into which he shall have entered upon request of the promisor, although he is not bound to do so.

We are not acquainted with the Czechoslovak foreign trade practice. In our opinion, however, recourse to the legal institution of the promise of indemnity is likely to be had when, e.g., all-national interest attaches to the conclusion of the transaction, whereas the party concerned is unable to accept the risk concomitant of the transaction. In this case a superior organ will have to take the risk implied in the transaction. The promise of indemnity is a prominent function of the promisor (the obligee enters into legal relationship with a third person on the request of the promisor). The promise of indemnity draws a line between promisor and bank guarantee, where the banker, though

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important, is a secondary party, as the basic transaction may be concluded even without the intervention of the bank. The promise of indemnity implies the assumption of a risk and not a limitation of the risk, as is the case with a banker's collateral security or a bank guarantee (the provision of article 673 of the Czechoslovak Code concerning the obligations of the client in connexion with the bank guarantee).

That there is a similarity, in the Czechoslovak acceptation of the term, between a bank guarantee and a promise of indemnity is confirmed by article 674 of the Code according to which, whenever the performance ensuing from the bank guarantee is conditional on the liability of a third person, the provisions governing the promise of indemnity have to be applied according to their sense.

The relevant provisions of Hungarian statutory law, and also the position taken by Hungarian jurisprudence, on the whole agree with the provisions an d doctrine, respectively, of German statutory law and German jurisprudence in the matter of Bürgschaft und Garantie (Bankgarantie). The rules governing suretyship have been taken up in articles 272 to 276 of the Hungarian Civil Code. Under a contract of suretyship the surety undertakes to make performance to the obligee if the obligor shall fail to perform. When a bank has undertaken suretyship the surety cannot by way of putting in a plea demand that the obligee shall first attempt to recover the sum due him from the obligor (liability as joint and several surety).

The Hungarian Civil Code is not acquainted with the institution of the guarantee (bank guarantee) in its acceptation in international trade and commerce. On the other hand there are opinions that the section of the Hungarian Civil Code on guarantee (article 248) admits of a construction which would embrace a guarantee not only for performance by the obligor, but also for the performance of another person, although it is beyond doubt that a guarantee stands for an almost unconditional undertaking for the faultlessness of the thing or chattel, and in this sense it is close to a warranty. For want of a statutory settlement of the question, Hungarian jurisprudence takes the position that in its essence a guarantee implies that the person entering into a liability for the performance of another person is liable for damages in the event of non-performance of this other person.

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Even if a suretyship and a guarantee in the economic sense serve the same purpose (namely the limitation of the risk), legally there is an essential difference between the two. Briefly, this difference may be summed up as follows. The surety performs for a person other than he himself, i.e. for the principal obligor, whereas the guarantor performs for himself. Suretyship is a subsidiary undertaking, whereas a guarantee contract is an autonomous undertaking of obligations. The guarantor cannot put in the pleas to which the obligee is entitled under the underlying transaction. The fact of the undertaking of an obligation of guarantee by itself does not create a legal relationship between bank and debtor, i.e. the debtor whose performance the bank guarantees to another person. There is no statutory assignment as in the event of the performance of the surety. For the payment made under the guarantee contract the bank is reimbursed by the guaranteed person on the ground of a contract of agency between the bank and the guaranteed person to offer a guarantee. As to time sequence, this contract of agency precedes the undertaking of the guarantee. Hence it is the essence of a guarantee to offer a recompense to the beneficiary for a loss owing to an unsatisfactory performance rather than the assumption of the obligation of the debtor for the latter's benefit.

When what has been set forth as to the legal nature of a guarantee above is compared to the typical wordings which appear on the printed forms of the letters of guarantee issued by banks, the remark may appear justified that in general the latter speak of the performance or non-performance of a third person rather than of the supervention of a result, or of an indemnity. The reason is that in particular the bank guarantees in current use in international trade in general refer to a damage in a relationship to performance or non-performance, although in a number of instances the guaranteed performance cannot even be supplemented by a similar performance of the bank. In fact the performance of the bank merely consists of payments in terms of money. The subject-matter of a guarantee is an interest of the beneficiary attached to the performance under the basic transaction defined in the contract in terms of money.

However, all that has been said on the subject of a guarantee does not apply to all types of a bank guarantee. The type of bank guarantee here discussed well

agrees with the essence of tender guarantees or guarantees of performance. On the other hand, the economic content of a guarantee for refunding advances, or the guarantee of the payment of the purchase price, i.e. guarantees usual in practice beyond those mentioned above, is a different one. In the guarantee of the repayment of advances the bank guarantees the advance payment of the beneficiary in the event that owing to a breach of contract of the contractor the buyer withdraws from the contract. Here there is no case of an interest of the beneficiary attaching to the basic transaction: the objective is to make it easier for the buyer to recover advances already made. Under a guarantee of the purchase price the bank guarantees the payment by the buyer of the full purchase price. Since the bank has to pay the larger amount at first notice without going behind the legal relationship between seller and buyer, this type of guarantee is of rare occurrence. The guarantee of the purchase price ensures that notwithstanding a faulty performance the seller may receive the quality claims of the buyer in possession.

Undoubtedly these latter two types of guarantees constitute another category of the bank guarantee. Whereas the tender guarantee, or penalty, and the performance guarantee both guarantee the interest attaching to the contract on a flat-rate system (the designation "penalty" may be given to this type of guarantee), and have the function of a contractual guarantee, the guarantee of the repayment of advances and the purchase price guarantee have not merely the character of contractual guarantees, but are at the same time methods of payment, or a method of repayment. In this respect these guarantees come close to a documentary credit. Naturally a documentary credit is a "par excellence" form of payment (although it has also a character of a guarantee given for an obligation), whereas the guarantee of a repayment of advance, and of the purchase price are as methods of performance of a subsidiary character only. As a matter of fact the beneficiary has in principle to apply to his partner for payment or repayment.

From another aspect the tender guarantee, the performance guarantee and the guarantee of the purchase price tend towards a realization of the underlying transaction (in the first two instances for the benefit of the buyer, in the latter instance for that of the seller). The guarantee of a repayment in advance

cannot have this function. In fact this guarantee is established to deal with the event of a frustration of the contract, and its purpose is to compensate the shift in the financial position of the parties owing to the advance payment.

Finally, the particular guarantees may be brougnt into juxtapositon to each other also as regards the party to the basic transaction whose interest the guarantee in question is called to safeguard. The tender guarantee, the performance guarantee and the guarantee of repayment of advances safeguard the interest of the buyer, whereas the guarantee of the purchase price those of the seller.

As regards the legal content of a guarantee, we would add to what has been set forth at the comparison of suretyship and guarantee the following. In our opinion a bank guarantee is not merely a sub-species of guarantee, i.e. it does not differ from it only in that it has a specific subject. The essence of a bank guarantee lies namely in the fact that the bank makes payment at the first call, without scrutiny of the lawfulness of the claim. This does not only mean that the bank cannot put in a plea to which its client would else be entitled under the basic transaction, but also that the bank cannot insist on a numerical substantiation of the loss by the beneficiary, as the guarantee offers a lump sum indemnity. None of the statutory regulations governing the guarantee contract, the contract of indemnity, or the promise of indemnity, declares that the guarantor cannot insist on the beneficiary's producing numerical evidence of his loss.

III

As regards the section of the Report relating to guaranteeing payment of drafts by an aval (A.II.4) we should like to note that whereas the first sentence of paragraph 15 speaks of guarantees given by endorsement pour aval of drafts, in the following sentence it speaks of an aval under the Geneva Convention providing a Uniform Law of Bills of Exchange and Promissory Notes. Since in the Common Law countries a surety for the payment of a bill, as such, is unknown, a guarantee is in general undertaken camouflaged as the liability of an endorser of a bill. For that matter it is usual in Common Law countries that recourse is

had under the law relating to bills to the liability of any other person whose signature appears on the bill (endorser, drawer). Moreover, cases are known when the principal debtor under the basic contract figures on the bill merely as a debtor liable for recourse, and vice versa the surety may undertake the liability of the acceptor. Finally, in the law of bills of the Common Law countries, suretyship may take up the form of a joint acceptance when the drawees of the bill are two distinct persons.

IV

Finally, we should like to comment on chapter A.II.5 dealing with problems related to the types of guarantee in general and in particular.

In paragraph 16 of the Report, in addition to the types of guarantee current in international trade (tender guarantee, performance guarantee, guarantee for the repayment of advances), among the forms of guarantee used in international transactions there figures the guarantee of the purchase price, which may be integrated into the notion of a guarantee in a sense wider than used in paragraph 4. Whereas the guarantees referred to in the Report offer a coverage up to 5 to 10 per cent of the value implied in the underlying transaction, the guarantee of the purchase price extends to 100 per cent of the value. On the other hand this guarantee is merely a subsidiary undertaking. Rarely also guarantees of the purchase price up to 100 per cent of the value of the transaction may be encountered.

Concerning paragraph 17 of the Report on certain problems in connexion with the guarantee, we should like to make the following observations:

(1) With respect to specified formalities: In conformity with article 262, paragraph 2, of the Hungarian Civil Code, no suretyship can be undertaken unless in writing. For want of a statutory regulation of the guarantee (bank guarantee) there is no such provision in this connexion. In any case, in practice bank guarantees are committed to writing. This is true partly because the conclusion of a deal or its coming into effect is made conditional on the delivery of an instrument containing the undertaking of a guarantee, and partly because the written form is in agreement with banking procedure.

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(2) With respect to the validity of the promise for penalties. As far as Hungarian legal practice is concerned, the problem of the validity of a guarantee undertaken for the payment of a penalty does not even emerge. In Hungarian law, for the very reason of the want of a statutory regulation, there are no limitations whatever in force as regards the claims or debts for the settlement of which a guarantee may be undertaken.

(3) With respect to the need for a valuable consideration: in our opinion the problem of a valuable consideration is one that has to be settled by Common Law jurists in the first place.

(4) With respect to the capacity of the guarantor to undertake obligations: here the Report no doubt refers to what has been made clear in paragraph 14, i.e. to the circumstance that in certain countries, as in the United States of America, the national and state banks refuse to accept risks implied in a guarantee. In our opinion a removal of the difficulties comes within the jurisdiction of the national legislatures of the States concerned. This does not, however, preclude an appeal on the part of the United Nations Organization to the competent organs of the countries concerned, that appropriate measures should be taken to remove legal obstacles in the way of international trade.

(5) With respect to choice of law: in the same way as we have seen in connexion withthe problems arising from a differential legal notion or statutory regulation of the guarantees, much of the weight is removed from the problem of the conflict of laws by the circumstance that in view of their freedom of contract the parties may define the content of their contracts. Even beyond this freedom, private international law authorizes the parties to choose the law which they would have to govern their transactions. In international banking procedure these and similar stipulations may be encountered too.

The Hungarian Code of Private International Law, now in process of drafting, provides in its Special Part of the Law of Obligations (Contract Law) that as to guarantee, are included also a banker's guarantee. Although the Draft Code does not mention the guarantee (bank guarantee) as a specific type of transaction, still the rules and provisions of the General Part of the Code obviously apply also to the guarantee. In the first place, for both the surety and the guarantee the law stipulated by the parties is normative. When the parties have failed to

choose the law, both the surety and the guarantee will have to be judged by the personal law of the characteristic service. For instance, for a banking transaction the law of the seat of the bank will be normative with the proviso, however, that to the content and the extent of the obligation of the guarantor the law valid for the principal obligation will be applicable. As regards the creation of a contract, further the substantive conditions of its validity the lex causae for the formal requisites of the contract in their relation to the surety and guarantee the lex loci contractus will be normative. The legal relationship between the bank undertaking the guarantee and the client is governed by the law of the bank as that of the agent.

For our part, we suggest that in the event UNCITRAL decides to draw up a standard wording for the bank guarantee, the law of the bank undertaking the obligation should be stipulated as the law governing the guarantee.

Finally, in this connexion we should like to make this comment concerning paragraph 14. In this paragraph mention is made of the circumstance that in certain countries claims arising from guarantee contracts cannt be enforced at law, on the ground that owing to their alleged retaliatory or punitive character, the judiciary considers such contracts null and void. Such a position is alien to the Hungarian legal approach.

Paragraph 18 raises the problem of the conditions under which the beneficiary would be entitled to claim under a guarantee. In order to reduce the risk of double performance, in the opinion of the writers of the Report it might be necessary to limit the risk arising from a unilateral determination by the claimant under the guarantee as a party to the underlying transaction, with respect to the contractor's performance. As an example, the Report refers to "cases where the beneficiary, under the original contract is entitled to recoupment for partial performance". This is in fact a genuine problem. Still, we should like to go further: in a guarantee of the purchase price the case might occur that the beneficiary seller fails to deliver, and yet he claims under the guarantee. Here the question may be asked, whether or not this risk is by nature concomitant of a guarantee as an autonomous unconditional promise of payment. In the great family of bank guarantees the surety is known as a subsidiary obligation, where the obligor may put in a plea on the ground of the underlying transaction. Also

the documentary credit or the letter of credit is well known as an autonomous obligation, still it is made conditional on the delivery of certain specified instruments. Finally, there is the guarantee which is not only autonomous, but in our opinion in its essence an unconditional undertaking of obligations. Even if the case in which the obligation of payment by the guarantor reaches maturity is specified as a condition, this condition will be a formal one only, as in our opinion when the guarantee is enforced the mere reference to the fact creating the reason for enforcing it will suffice. In fact the bank cannot check up on the existence of this reason, as by this the bank would enter into an examination of the underlying transaction, which it could not do even in the event of a documentary credit attaching to certain conditions, this being the bank's right only when it undertakes a suretyship.

A construction of the guarantee in this sense is supported also by Hungarian banking practice. Here a declaration containing the undertaking or an obligation is given or accepted as a guarantee, according to which the bank meets its obligation of payment on first notice without going behind the legal relationship existing between seller and buyer.

Obviously the position we have made clear above, i.e. that by nature a guarantee is an autonomous and unconditional legal transaction, does not and cannot limit the freedom of the parties generally recognized in civil law to choose the type of contract. Thus, the parties may enter into a legal commercial relationship representing the borderline between two types of contracts. However, for a legal transaction of such a type the problem of qualification will necessarily emerge, e.g. a promise to make the payment of the purchase price conditional on the delivery of certain documents will qualify as a documentary credit rather than a guarantee. As a matter of fact it is a general principle that it is the actual legal content of the transaction rather than the wording that determines the legal qualification. Consequently, a guarantee making payment conditional on the delivery of certain documents will be governed by the rules of a documentary credit (c.f. Uniform customs and practice for documentary credits, General Provisions and Definitions, paras. (a) and (b)).

Still there remains a difference. If the buyer has caused a documentary credit to be made out in compliance with the contract, he will be relieved of all other action in connexion with the payment. The seller, i.e. the beneficiary under the documentary credit, will have to claim the purchase price from the bank. The buyer's liability for the purchase price will revive only in extraordinary cases, e.g. when the bank has gone into bankruptcy. On the other hand, in the event of a guarantee the buyer will have to take care of the payment of the purchase price. In the ordinary course of things the seller will be bound to apply to the buyer for payment first. If the seller does so through the bank offering the guarantee, the bank will make payment for and on behalf of the buyer, and not on the ground of its own guarantee. The seller may apply to the banking institute giving the guarantee only when the buyer repudiates payment. This difference follows from the circumstance already referred to above: in addition to a contractual security, a documentary credit is a form of payment agreed upon in the contract whereas a bank guarantee is a method of settlement of a subsidiary character only and is separate from its function as contractual security.

We should now like to revert to the cases when the beneficiary, apparently in a lawful manner by giving proper reasons for his recourse to the guarantee, demands the guaranteed amount obviously in bad faith: e.g. when he has not made delivery at all. As we see it, the guarantor bank may have the possibility of repudiating payment as in any other legal transaction though, from the point of view of the guarantee, unlawfully. Cases of this category have in all certainty occurred in international banking practice. In our opinion there is nothing extraordinary in such a repudiation of payment. This will not detract from the suretyship character of the bank guarantee. In point of fact, a case of this type might occur in the event of a documentary credit as well as of a surety. When the beneficiary demands payment in bad faith, he will obviously refrain from going to court. Still, if he nevertheless institutes proceedings against the guarantor bank, the bank may set up a defence successfully by invoking bona fides and honour (bona fides, Treu und Glauben), a principle available under several codes. Article 5, paragraph 1 of the Hungarian Civil Code prohibits a misuse of law. A beneficiary enforcing a claim under a bank guarantee in bad

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faith will be open to a charge of abuse of the law. This right does not create a problem of unjustified enrichment: it merely serves to protect him against a breach of contract by the other party to the contract.

There is no doubt that in this case a blot will be cast on the position we have previously taken in the matter, i.e. the autonomous and unconditional character of the bank guarantee. In point of fact, the bank subjects to a scrutiny the underlying original transaction. However, in practice before meeting its obligation under the guarantee the bank will anyhow contact its client, to whom the bank stands in contractual relations as his creditor and keeper of his account, in order to discuss with him such action as may be taken. The bank might even have committed itself to do so in the contract itself. Also we have to remember that a bank concerned about its international reputation will disown its undertakings only in an extreme case.

Here we should like to note that a case might arise when the bank subjects the relationship between its client and the beneficiary to scrutiny. This will be the case when a clause in the bank guarantee declares that the obligation of the bank under the guarantee will be reduced proportionally to payments made, or delivery effected. However, in this case the banking institution will in the light of the facts of the underlying transactions scrutinize its obligations to the beneficiary assumed by its declaration of guarantee and to its client assumed by its commitment to offer a guarantee.

Obviously there is in fact a need for a regulation of the right of the banker to repudiate payment. In the event the bank guarantee is defined and put into writing in terms of usage, the appropriate action would be specifically to define this right of the bank. One provision would authorize the bank to repudiate payment under the guarantee if it is satisfied that the sum claimed by the beneficiary has been paid by the buyer wholly or partially (double performance). In this event the bank has become acquainted with the fact of payment in its capacity as the buyer's banker entrusted with making payment; i.e. it is the bank that has made payment for and on behalf of the buyer.

In connexion with a set-off or counter-claim, it is our opinion that the bank should be barred from putting in a plea of set-off, to which otherwise its

client would be entitled, for in this case the bank would subject to scrutiny the relation existing between the parties. In conformity with article 337, paragraph 3 of the Hungarian Civil Code for joint and several liability, the claim of the co-obligor cannot be used for set-off.

On the other hand, as regards the extinction of the counter-claim of the bank with respect to the beneficiary by way of set-off, we believe that such a right should be granted. This will of course entail the extinction of the obligation of the client of the guarantor bank. In the Hungarian Civil Code, there is a provision to this effect (article 337, para. 1).

V

Among the guarantees used in continually expanding international trade, the bank guarantee takes an ever more prominent part. In the light of this summing up of the statutory regulations, opinions of jurisprudence and banking procedure associated with the legal institution of a bank guarantee (for which the Report provides an excellent foundation and to which we, too, should like to contribute), we are inclined to believe that UNCITRAL would serve the interests of international commerce and trade best if it did not adopt the statutory provisions of any one of the legal systems for the bank guarantee: Instead, in its future work, UNCITRAL might focus its attention on the bank guarantee as it is used in every-day practice of international trade (though somewhat remote from the notion of guarantee of varying content usually occurring in statutory regulations) and, keeping in mind the particular types of bank guarantees, UNCITRAL might make use of the results of banking practice.

Reverting to the proposals put forward by the Hungarian delegation in this year's session of UNCITRAL in Geneva, we would suggest that the Commission request a qualified organization or persons to study the problems associated with bank guarantees, to draw up specimen bank guarantees, and possibly to put forward recommendations for a standard wording of the bank guarantee.

B. Securities

I

The Report discusses the problems of security interests in property extensively and in detail. The method followed by the Report offers an opportunity for the survey of the relevant legal institutions of the various countries and also for an analysis of the essential features of these institutions. The Report is extremely useful also because reference is made in it (if only in outline) to certain unsettled points associated with security interests in things that are apt to crop up in the field of the law of international payments and that await settlement. The addendum to the Report offers valuable assistance to those embarking on a study of the problem, reviewing the relevant legal institutions of the particular countries in detail.

II

Following are our comments on the exposition of both the Report and the addendum.

With respect to paragraph 21 of the Report, we should like to add that in our experience recourse to security in property is had in connexion with international credit transactions in the mutual legal relations of the parties even without the intervention of a banking institution, even if not too frequently. However, in our opinion, in the wake of a consolidation of the relevant legislations, the situation will, in all likelihood, undergo a change.

The Report and addendum go into minute details in discussing the most important types of security brought under regulation by the law of the particular countries. In addition to the legal institutions discussed in the Report and the addendum, in our opinion owing to its frequent occurrence in banking procedure, it would be useful to make mention of the institution of a trust receipt. This device is in current use in connexion with the financing of trade and in particular of international trade. A "trust receipt" is made out by the buyer; in it he undertakes a variety of obligations to a bank that extends to him a credit in the one way or the other for the payment of the purchase price of goods of which he has taken possession by means of documents delivered to him by the bank.

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Dependent on the underlying agreement, trust receipts may differ in content. Often the bank reserves the right to prohibit the sale of goods by the buyer, or obliges the buyer to store the goods in the name of the bank, or exercises supervision over the goods. The bank may also have the right to demand that payments made in respect of partial sales be remitted directly to the bank, etc. The essence of the undertaking of the debtor lies in the fact that he is holding the documents, or the cleared goods, in trust for the bank. The buyer is merely a pledgee of the bank until he has settled his debt, i.e. the debt which arises from the fact that the bank has made payment of the purchase price of the goods to the creditor, or has undertaken a liability for it under a bill of exchange.

In the judicial practice of a number of countries, under a trust receipt the bank has priority in the event of a bankruptcy of the debtor. The special right of satisfaction of the beneficiary (i.e. the bank) is recognized in the legal system of the United States of America. As a matter of fact, a majority of the States acceded to the Uniform Trust Receipt Law of the State of New York of 1934. Little is needed, perhaps merely some sort of an entry on a public record, to legally support a "mortgage in chattels". Even without such an entry, (mainly in the practice of the Common Law countries, moreover, as has already been mentioned) in some places even in legislation there is a tendency to recognize a certain in rem effect of the trust receipt, beyond the effects under contract law. The institution is presently in a state of development.

Similarly, owing to its peculiar nature, the institution of "factoring" deserves mention. The institution has made headway in particular in the United States of America. Although the institution itself cannot be considered a security interest in property in the strict sense of the term, still in its effects it shows certain similar traits to a pledge, or a mortgage in intangible assets. Essentially in factoring the creditor assigns to the factor his claims, to accounts arising from contracts for the sale of goods. The factor, will then be entitled to collect payments and bear all risks. Assignment is effected against a valuable consideration and recourse to factoring is had in connexion with sale contracts in which the claims of the seller are not represented by negotiable and discountable instruments. However, the factor will not have to take the risk when non-payment is due to a defect of the goods.

In our opinion the addendum appropriately points out that in modern commercial practice a type of chattel mortgage would be welcome: under such an arrangement an agreement of the parties would establish a mortgage for the benefit of the creditor without the actual delivery of the chattel. From a survey of the relevant matter it appears that, in the law of a number of countries, without the actual delivery /traditio/ of the goods no chattel mortgage can be created. Notwithstanding the rather rigorous provisions of statutory law insisting on an actual delivery of the chattels, in many countries the mortgaging or pledging of chattels (i.e. goods, stocks, machinery, cargoes, etc.) has developed in trade, mainly in foreign trade; whose actual delivery or traditio (or any other act equivalent to delivery and to guaranteeing the creditor's exclusive right of disposition) have been superseded by symbolic acts, whose mortgage or pledge creating effect has not been recognized by the law of several countries. In addition to the institutions referred to in the Report and the addendum (chattel mortgage, etc.) the Austrian Civil Code recognizes this form for chattels whose "corporeal transfer from hand to hand" is not feasible; however, some sort of an indication is needed by which anybody may easily recognize the fact or mortgaging or pledging (art. 452). On the model of this provision the Austrian "Mastkreditgesetz" (Cattle Fattening Act) of 1932 provides facilities for pledging cattle /for guaranteeing the fattening credit/ where the cattle are distinguished by a brand. The Swiss Civil Code (art. 885) contains provisions governing "cattle mortgage" which may be created as a security of loans advanced by banks or co-operatives by entries on a public record.

In this connexion, mention may be made of the establishment of the grain mortgage in Hungarian law, since abolished. On definite quantities of grain stored in a granary, or store-room, a mortgage may be created to guarantee short term credits. The pledged chattel remains in the possession of the debtor. However, together with the declaration of mortgage the mortgagor delivers to the mortgagee a schedule indicating the kind of grain, its quality and quantity to the creditors. The entry of the schedule on a public record constitutes the absolute effect of the mortgage.

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Hungarian civil law contains a rather noteworthy provision as far as chattel mortgage is concerned. In the Hungarian Civil Code (art. 262) on a "lien securing bank credits", the special provision has been made that a lien will attach even without delivery of the property under lien. The bank will stipulate the lien in the credit contract and the lien will be created on the disbursement of the credit sum. For a lien securing bank credits this is the constitutive act instead of transfer. However, as regards chattels under a lien remaining in the safe keeping of the debtor, the bank usually stipulates that the debtor may not dispose of them unless by agreement of the bank. The lien securing the bank credit guarantees priority of satisfaction for the bank. When the chattel comes into the possession of the bank, the bank may recover its claim under the loan contract from the chattel under lien without the intervention of the court. It is a peculiarity of the chattels under lien guaranteeing bank credits that the chattels may change in the course of the productive or trading activities of the debtor (fluctuating lien).

III

From the rather copious material of the Report and the addendum and also when attention is given to the institution of Hungarian law of a "lien securing bank credits", it appears that as regards the security interest in property related to chattels, there is a marked tendency to create a security interest in property even without the delivery of the thing by the creditor. The principal problem which emerges here is the absolute effect of the security, i.e. its validity also with respect to third persons. As a matter of fact, an absolute effect cannot be created for international trade unless by an entry of the security on some sort of a public record. And here again, owing to the diversified nature of the things on which a lien or mortgage may be created, several limitations to an entry on a public record may become manifest.

In our opinion modern trade and commerce calls for greater elasticity in the statutory regulation of chattel mortgage or lien. This need would be served best by a universal institution of absolute effect of chattel mortgage. It is for this reason that we agree with both the Report and the addendum with respect to the

light they cast on the problem. It would be useful for UNCITRAL to request a qualified organization or person to study the uniform international regulation of chattel mortgages and the potentialities of an establishment of public records for the entry of the mortgages. The report on the results of the study could then be submitted to UNCITRAL.

KENYA

[Original: English]
8 December 1969

In general the law relating to guarantees, suretyship and securities applicable in Kenya is the same as that prevailing in England. However, the Permanent Mission of the Republic of Kenya to the United Nations would like to draw the attention of the Secretary-General to two particular statutes. The first is the Chattels Transfer Act (Cap. 28) with particular reference to the giving of a chattels mortgage as security. The second is the Guarantee (Loans) Act (cap. 461 of the 1967 Revision as amended by Act No. 44 of 1968) which governs the giving of guarantees by the Government of Kenya.

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MEXICO

/Original: Spanish/
18 December 1969

Personal and real guarantees in Mexican law

Personal guarantees are guarantees furnished in respect of a debtor's obligations by a third party who undertakes to answer for those obligations with his personal assets.

Real guarantees (securities) are guarantees involving property, rights, and even (as, for example, in the case of guarantee trusts and mortgages on enterprises) the assets of the debtor in such a way that the owner is answerable, to the extent of the value of the property and through a special charge upon it prescribed by law, for the performance of the obligations assumed by the debtor in a specific legal transaction.

I. Personal guarantees

These may be general guarantees, applicable to any legal contract or transaction, or special guarantees, applicable solely to specific transactions or relations.

1. General guarantees include:

(a) The assumption by a third party, as a joint and several debtor, of the obligations contracted by the debtor.

Under Mexican law, joint and several liability is not presumed in either civil or commercial cases; it must result from an agreement or from an express provision of the law (article 1988 of the Civil Code). However, there are important exceptions to the foregoing rule in commercial law (and also in, for instance, taxation and labour law). The Credit Instruments and Credit Transactions Act provides that the parties - acceptors, drawers, endorsers and givers of an aval - to credit instruments (bills of exchange, promissory notes, cheques, bonds or debentures and pledge notes) are jointly and severally liable (articles 154, 174, 196, 228 and 251) as are co-debtors in respect of credit transactions governed by the Act (article 4). Such credit transactions include the borrowing of securities (reporto), bank deposits (cash, securities and merchandise), the opening of credits (clean, confirmed, revocable and irrevocable,

overdraft privileges and credit secured on the equipment and the product (crédito de habilitación de avío)), pledges and trust transactions.

(b) Surety bonds (contrato de fianza), whereby the guarantor undertakes to pay the creditor should the debtor fail to do so (article 2794 of the Civil Code).

As in the case mentioned above, a suretyship may be furnished in respect of any contract or transaction under civil or commercial law; it may even be required by court order and can apply to situations and relations as far removed from private law as those resulting from criminal proceedings, so that the defendant may secure a conditional release (on bail).

Unlike joint and several liability, which is governed exclusively by the Civil Code, suretyship is subject also to provisions of commercial law (the Surety Companies Act). In addition to establishing rules as to the obligations of companies whose business consists entirely of furnishing this type of guarantee, the Act governs the actual agreements concluded with such companies (surety-company bonds).

Its character as a commercial act or transaction derives from its being an act accessory to another, principal act which is of a commercial character, or from the fact that it is furnished by a surety company.

Mexican law recognizes as valid the waiving of the benefit of discussion (beneficios de orden y excusión), or in other words, of the right to compel the creditor first to exhaust his remedies against the principal debtor and his property for the discharge of his debt (article 2814 of the Civil Code).

A surety-company bond of the kind mentioned enables the company furnishing it to guarantee not only a current obligation of the debtor but also any future obligations which may arise, for example, out of the contract of sale or long-term delivery contract concluded with the seller. In this respect, the bond serves the purposes and interests referred to in document A/CN.9/20, paragraph 8.

Surety companies are also permitted by Mexican law to guarantee the honesty of the staff of an enterprise and may accordingly obligate themselves to cover losses sustained through theft, fraud or embezzlement by employees or workers (fidelity bonds).

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2. Special guarantees include:

(a) The aval, or specific guarantee concerning a negotiable instrument, which is governed by the Credit Instruments and Credit Transactions Act, articles 109-116, as concerns bills of exchange, but is also applicable to promissory notes (article 174), cheques (article 196) and pledge notes (article 251). The aval guarantees that the instrument will be paid in full or in part; it may be given by a third party or by any party to the instrument, and it must be written on the instrument or on a slip affixed thereto (articles 109-111). Like other parties liable on a negotiable instrument, the giver of an aval is jointly and severally liable with the party for whose account it is given, and his undertaking is valid even when the liability which he has guaranteed is inoperative (article 114).

In the case of international credit transactions, the parties extending credit frequently request a guarantee from the Mexican Government, which is usually given in the form of an aval of the Federal Government issued by Nacional Financiera S.A. with the express authorization - as required by law - of the Ministry of the Treasury and Public Credit.

(b) Right of lien (Derecho de retención). This right is granted in favour of the party to a contract who is bound to deliver goods, if the other party fails to pay the price.

In substantive law, the lien operates only when expressly provided for in positive law. Such provision is made in civil law as concerns buying and selling (article 2286 of the Civil Code), barter (article 2331), storage or deposit (articles 2528, 2533 and 2534), construction (article 2644) and lodging (article 2669), and in commercial transactions as concerns commission (article 306 of the Commercial Code) and the carriage of goods (article 591, section VII, of the Commercial Code). A party who is bound to give or do any thing has a kind of lien if the other party to the contract fails to fulfil his obligation; this results from the implied annulment clause applicable to reciprocal obligations (article 1949 of the Civil Code), and the courts may allow the benefit of it either to the party demanding performance of the contract (inadimpleti non est adimplendum) or to the respondent (exceptio inadimpleti contractus).

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II. Real guarantees

Under Mexican law there is no tacit, general guarantee, even in the case of bankruptcy, whereby all the property of the debtor (as under a general mortgage) constitutes security for all his obligations (article 2919 of the Civil Code). On the contrary, real guarantees, firstly, are specific to the property (movable or immovable) indicated in the relevant contract; secondly, are limited - numerus clausus - as prescribed in positive law; and, thirdly, in order to be valid against third parties (other creditors of the common debtor) must be recorded in the property register (articles 2861 and 2919 of the Civil Code).

The autonomy of the parties does not operate in the case of real guarantees (securities) as it does in the case of personal guarantees (document A/CN.9/20, paragraphs 33 and 36). The real guarantees or securities provided for in Mexican law are: a retention of ownership clause in contracts for the sale of goods on credit terms; a pledge in the case of movable property or a mortgage in the case of immovable property (although a commercial enterprise can also be mortgaged); bank guarantees in industry and agriculture and, in recent years, guarantee trusts.

(a) The retention of ownership clause. The Mexican Civil Code provides for the retention of title to the goods by the seller in the case of sales on credit terms, stipulating that this pactum reservati domini donac pretium solvatur shall be valid against third parties only if it is recorded in the property registers and the goods are not fungible, are individualized and are fully identifiable (see document A/CN.9/20/Add.1, paragraph 10).

In such cases, the buyer is prohibited from alienating the goods until he has paid the price in full, and the seller is allowed the right to repossess them in case of non-performance of the contract, or even bankruptcy of the buyer, and to collect a rental for the time during which the goods were in the possession of the buyer (article 2312 of the Civil Code).

There are no provisions of commercial law relating to this guarantee, but it is also applicable to commercial contracts.

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(b) Pledge. According to the legal definition in the Mexican Civil Code (article 2856), this is a right in rem constituted in respect of alienable movable property to guarantee the fulfilment of an obligation and priority in its payment.

The pledge may include earnings, credit instruments (e.g., shares, bonds and debentures issued by joint-stock companies), and even debt-claims (articles 2857, 2861 and 2865). In the case of tangible property, actual or constructive delivery to the creditor is required (article 2858).

Like a suretyship, a pledge may be civil or commercial and is provided for both in ordinary or civil law and in commercial law (articles 334 et seq. of the Credit Instruments and Credit Transactions Act).

Actually, the provisions of commercial law concerning pledges and the scope which article 334 of the above-mentioned Act gives to commercial pledges are such as to leave little room for the civil-law pledge, which would be restricted to things movable that are neither merchandise nor credit instruments or commercial credits; and if this guarantee is not constituted as accessory to a commercial transaction, it will not be used between traders in the course of their business operations or transactions.

It is also worthy of note that, whereas under civil law the pledge may remain in the possession of the debtor (article 2859), under commercial law a pledge is not permitted without dispossession of the debtor in favour of the creditor himself or a third party.

It is pertinent to note that in the case both of pledges (article 2883 of the Civil Code and article 334 of the Credit Instruments and Credit Transactions Act) and of mortgages (article 2916), and even, it would appear, of the bank guarantees mentioned in (d) below, it is forbidden to agree that the property pledged will be assigned to the creditor if the debtor fails to fulfil the obligations guaranteed, otherwise than by court order (prohibition of annulment clauses). For such an agreement to be valid, it must be concluded and stipulated subsequent to the creation of the guarantee (whether a pledge or a mortgage).

This real guarantee under Mexican law has the characteristics specified in document A/CN.9/20/Add.1, paragraph 5, sub-paragraphs (i) to (iv).

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(c) Mortgage. In Mexico, mortgage has traditionally been a guarantee constituted on immovable property (although the Civil Code does not exclude its application to movable property also). Mortgaged property, unlike pledges, is not delivered to the creditor, but like a pledge a mortgage "gives the creditor the right, in case of non-fulfilment of the obligation guaranteed, to be paid with the value of the property in the order of priority prescribed by law".

A mortgage extends to accessions and improvements to the property, movable objects fixed to and incorporated in the property, and also, if so agreed, industrial earnings (interest) and rents which are due (articles 2896 and 2897).

Furthermore, Mexican law permits the use of mortgages to guarantee obligations to order (e.g., documentary obligations on credit instruments such as bills of exchange, promissory notes, bonds or debentures), in which case the guarantee is written in the body of the instrument and is transferred by endorsement of the instrument, without need to notify the debtor or to register the transfer. Their use is even permitted to guarantee obligations to bearer, in which case the transfer is effected merely by delivery of the instrument, without any other requisite (article 2926).

Lastly, banking legislation permits the mortgaging of the "entire unit of an industrial, agricultural or stock-raising enterprise" to guarantee public or private loans to the enterprise (article 124 of the Credit Institutions Act).

(d) Bankers' loans to agricultural and industrial enterprises. These include credits secured on the equipment and the product (créditos de habilitación o de avío) and commercial and agricultural credit (créditos refaccionarios), which are governed by the Credit Instruments and Credit Transactions Act (article 321). Both kinds of loan must be intended exclusively for the development of the enterprises in question, and the collateral comprises not only the machinery or equipment which is purchased with the funds lent or is covered by the supply or installation contracts involved, but also the immovable property of the enterprise itself (lands, factory or workshop), inventories of raw materials and manufactured articles, and the earnings of the enterprise.

The collateral is thus extremely extensive and consists of both movables and immovables; one feature of it is that the debtor retains possession of all the property comprising it.

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These loans - credits secured on the equipment and the product, and commercial and agricultural credits - as well as mortgages of the kind referred to in the last paragraph of (c) above, can be used to meet the need for supplies of machinery and plant to which document A/CN.9/20, paragraph 38, relates.

(e) Sequestration or attachment. Another real guarantee is the attachment or sequestration of property, by court order. The order is granted in favour of the creditor, whose claim must be based on an effective instrument (e.g., a bill of exchange or promissory note) which is not honoured when it falls due, so that the creditor seeks payment through the courts.

If the attachment relates to immovable property it must be recorded in the property register; if it relates to an enterprise it is effected through the sequestration of the enterprise; if it relates to movable property it is accompanied by sequestration and judicial deposit of goods, usually with a person designated for that purpose by the attaching creditor. Attachment does not affect other real guarantees constituted previously and has priority only over charges on the property constituted subsequently.

(f) Trusteeship (Fideicomiso). This transaction is governed by express provisions of Mexican law. A requisite feature of it is that the trustee should be a special credit institution (trust company), to which property and rights (fiducias causa) are transferred, in order to fulfil the purposes laid down in the agreement.

Since its introduction in Mexican law in 1924, the institution of trusteeship has developed remarkably and has been codified in articles 346-359 of the Credit Instruments and Credit Transactions Act.

The trust system (fideicomiso) is now also used to guarantee transaction through the transfer to the trustee of property or rights belonging to the trustor (the principal debtor), which can be allocated by adjudication directly to the beneficiary of the trust (the principal creditor) in the event of non-fulfilment of the obligations guaranteed. There is thus a "fiduciary transfer of ownership by way of security", in the words of documents A/CN.9/20 and A/CN.9/20/Add.1 (para. 9), on which this report is based.

This transaction, which cannot be considered a real guarantee in the strict sense, has the advantage of allowing the separation or earmarking of certain property to meet or guarantee a debt and of involving credit institutions whose solvency and reliability are assured through the supervision exercised over them by the State.

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III. Direct guarantees

In addition to the guarantees and securities described in sections I and II above, under which the obligations assumed by the debtor - as principal obligor - are secured by an accessory obligation of a third party and the assignment or pledge of property, there are other types of guarantee - in a general sense - which involve the participation in the transaction of third parties who assume or acquire the same obligor status as the principal debtor.

These consist mainly of confirmed irrevocable bank credits, which are governed by articles 317-320 of the Credit Instruments and Credit Transactions Act, and also by the rules of the International Chamber of Commerce.

By its participation, the bank undertakes to pay the value of the goods covered by a contract of sale between distant markets immediately upon receipt of all or some of the documents describing the goods purchased (invoice), their nature and quality (certificate of origin and quality), their clearance outwards from the seller's country (customs papers), transport (bill of lading) and insurance (the relevant insurance policy), according to the terms of the contract of sale and the instructions given to the bank by the parties.

UNION OF SOVIET SOCIALIST REPUBLICS

[Original: Russian]
10 December 1969

In view of the wide range of different practices and the considerable differences in national laws on the question of guarantees and securities as related to international payments, the proposals to unify the principles and practice relating to guarantees, and to provide better information on national regulations governing other types of securities, do seem to be timely.

The following practical problems should be taken into account in drafting unified principles:

1. International banking practice has developed certain types of guarantees (such as guarantees of payment on presentation, guarantees for repayment of advances, etc.), but these guarantees differ widely in their form. Every bank issues guarantees in its own accepted form, though companies often require guarantees from a foreign bank in a form which is acceptable in their own countries or by their own banks. This gives rise to difficulties and inconveniences in issuing guarantees.

2. In the absence of any general principles applied by all banks in the matter of guarantees, it is impossible to obtain a uniform interpretation of the basic provisions of guarantees relating to the extent of the bank's obligation, conditions for enforcing the guarantee, the period of its validity, etc. On the other hand, the need for such an interpretation does often arise, since many guarantees issued by foreign banks are drafted in the most general terms, whilst others go into minute details; and this makes it virtually impossible to enforce guarantees of both kinds in the same manner.

It might therefore be useful to unify the principles and practice relating, inter alia, to the following questions:

1. The concept of the bank guarantee, its characteristics, and terminology.

2. Types and forms of bank guarantees including:

(a) guarantees that payments will be duly effected (in favour of the exporter);

(b) guarantees for repayment of advances and guarantees against losses (in favour of the importer);

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(c) guarantees issued when tenders are invited (tender guarantees);

(d) guarantees relating to shipping.

The following should be regarded as the basic requirements for the guarantee:

(a) exact designation of guarantor, debtor and beneficiary;

(b) reference to contract or other legal basis;

(c) description of debtor's obligation;

(d) description of guarantor's obligation;

(e) amount of guarantee;

(f) indication of circumstances and other conditions for enforcing the guarantee;

(g) extent of guarantor's obligation (unconditional, conditional, on presentation of certain documents, or on demand);

(h) period of validity of guarantee.

3. Procedure for renewing guarantees, replacement of one guarantee by another, cases in which a bank may be absolved from complying with its obligation (cases of force majeure) and guarantor's right of objection (circumstances in which this may be exercised).

4. Conflict rules, for example, regarding the law applicable to the obligation under the guarantee or the legal capacity of the parties.

As a first step in the task of unification, the banking institutions of countries participating in international trade should be requested to submit copies of the forms of guarantees used by them.
