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Bank Guarantees in the Czech Republic

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ABSTRACT

The article is focused on the legal regulation of bank guarantees in the Czech Republic. Bank guarantees have a significant benefit for conducting foreign trade. Although the legal regulation in the Civil Code is relatively new, it follows on from earlier laws and international business practices. The article points out some specifics of Czech legal regulation and important court case law.

Keywords: bank, bank guarantees, customs of trade, issuer, debtor

INTRODUCTION

Czech law describes a bank guarantee as a written declaration where a bank agrees to pay a creditor's claim up to the amount specified in the guarantee deed if the debtor fails to pay the debt or if some other conditions set out in the guarantee deed are not met.

A bank guarantee as a means of security partly resembles suretyship. By virtue of a bank guarantee, a bank undertakes to a creditor to pay a certain debt on the debtor's behalf according to the contents of the guarantee deed. The legal concept of a bank guarantee came to the European continent from Anglo-American law and somewhat differs from the well-known institution of suretyship. While banks may also provide traditional sureties, bank guarantees are regulated in Czech law as a separate instrument in the form of a financial guarantee.

Historically, a bank guarantee is a relatively novel way of providing assurance. It originated in the United States of America as a type of security (also known as collateral) and its development and expansion to other countries can be timed to the 20th century, specifically to the 1940s. Bank guarantees evolved from suretyship, with which they share some common features. The legal provisions on suretyship are partially reflected in bank guarantees and the latter are even considered a type of suretyship.

Creditors sought to protect their claims against the debtor's default or insolvency through a third party – a trusted institution, specifically a bank. The credibility and relatively high certainty on the creditor's part that the bank will pay his claim, if need be, had made a bank guarantee a clearly advantageous method of securing a claim. The growing popularity of bank guarantees in the 20th century was also due to the increasing volume of goods transported among countries and even continents.

In trade, a bank guarantee can be used primarily to mitigate the commercial risk of default, both in domestic and in international trade. The practical reach of bank guarantees has gradually grown. Under Czech law, a bank guarantee can be used as a substitute for cash in cases where a security deposit is required in auctions, public procurement and customs procedures.

The institution of bank guarantee is regulated in Sections 2029 to 2039 of Act No. 89/2012 Coll., the Civil Code (the "Civil Code") in the form of a financial guarantee. The currently applicable legislation is a continuation of earlier provisions comprised in Act No. 513/1991 Coll., the Commercial Code, and Act No. 101/1963 Coll., the International Trade Code. This fact points towards both a relatively sound legal regulation and low incidence of legal problems in practice, which is also confirmed by the relatively scarce case law and literature in this field.

Bank guarantees are also fairly akin to letters of credit. They both give rise to the bank's obligation to pay a certain amount. However, letters of credit are a payment instrument, because the bank is always required to pay the set amount instead of the debtor. Hence, a letter of credit shows the exact amount to be paid by the bank, while a bank guarantee indicates the amount up to which the bank stands surety.

CUSTOMS OF TRADE

The statutory regulation is complemented – especially with regard to claims and obligations arising from international trade – by customs of trade, which become part of a legal relationship in the form of contractual arrangements.

The International Chamber of Commerce in Paris issued its Uniform Rules for Demand Guarantees (URDG) in 1992 under number 458. They apply to all bank guarantees, bonds and other payment obligations, except for standby letters of credit and accessory guarantees. Currently, this instrument is governed by Uniform Rules for Demand Guarantees URDG 758 – the 2010 revision. The latter replaced former URDG 458 in business transactions; moreover the URDG 758 version now applies on a wider scale, for example in procurement contracts and also in certain deals where demand guarantees and counter guarantees issued by banks had not previously been used.

Under number 524, the International Chamber of Commerce in Paris then issued the Uniform Rules for Contract Bonds (URCB), effective since 1994; a specific feature of these rules is that, when presented with a written statement issued by the beneficiary, the surety bank always examines whether and, if so, when the breach of contract occurred. This is why, unlike insurance companies, Czech banks very seldom use the URCB. Nonetheless, their popularity has been gradually growing, especially after they have been approved, e.g., by the Panamerican Surety Association (PASA), the Surety Association of America (SAA) and the International Credit Insurance & Surety Association (ICISA)).

Bank guarantees in the special form of a standby letter of credit are governed by the International Standby Practices 98 (ISP98), issued by the International Chamber of Commerce in Paris in 1998.

Standby letters of credit are considered a special type of letter of credit that operates as a guarantee. One could say that they are, in fact, bank guarantees dressed up as documentary credit. While a traditional letter of credit is used as a method of paying for the delivery of goods or services, and is activated once the terms of the contract are fulfilled, a standby letter of credit can be likened to an insurance policy. It is not intended primarily to facilitate payment, but rather serves as security should the contract terms be breached.

A standby letter of credit can be used to secure any payment obligations of the debtor, as well as a contract performance bond, warranty bond or a bond securing a tender offer. This means that it can fully replace a payment guarantee, a performance bond or a bond securing a tender.

Reasons for issuing a bank guarantee

Historically, bank guarantees have been linked in the Czech Republic primarily to foreign trade, where potential debt collection has always been more of a problem abroad than in purely domestic relations. In practice, a bank guarantee thus replaces the deposit of a certain sum of money or a guarantee in kind, etc. The purpose of a bank guarantee is to assure the creditor of the proper performance of his claim.

Over the course of time, national legislation has also introduced a bank guarantee as a specific form of compulsory security in some legally regulated relationships. This includes, in particular, provisions in the fields of customs law, public procurement and public auctions.

Pursuant to Section 41 of Act No. 134/2016 Coll., on public procurement, a tenderer may provide security, inter alia, in the form of a bank guarantee issued for the benefit of the contracting entity. The purpose of public procurement legislation is to create an environment where the contracting entity will be able to select the most advantageous tender on the basis of a transparent procedure and pre-defined criteria, and to create a non-discriminatory competitive environment among the relevant competitors.[1] On the one hand, such a security can dissuade from participation those suppliers who have no real interest in the procurement procedure and would submit a tender only to obtain certain information, without actually intending to enter into a contract should their tender be found most advantageous; on the other hand, the requirement for a security would be likely to discourage genuinely interested suppliers, especially in smaller tendering procedures.

Pursuant to Section 14 of Act No. 26/2000 Coll., on public auctions, as amended, the auctioneer may ask each bidder to provide a security deposit. The deposit may be provided in the form of a bank guarantee. The purpose is similar that of security provided in public procurement, i.e. to secure the bidders' future obligations in a specified amount and form, and thus prevent cases where a bidder lacks genuine interest in acquiring the item for sale.

Pursuant to Section 26 of Act No. 242/2016 Coll., the Customs Act, the payment collected by the State when goods cross the customs border (i.e. the customs duty) is secured by the provision of a security deposit, which can also take the form of a bank guarantee.

It is clear from the examples provided above that the original bank guarantee, which aims to facilitate the satisfaction of claims in international trade, is gradually expanding to areas where the performance of certain obligations or bona fide conduct of the parties is enforced through the requirement for some security. Since the provision of such security would tie up a certain portion of the debtors' or participants' cash, it can be replaced by a bank guarantee, which provides similar assurance for the creditor, while not restricting the debtor in the handling of

[1] Resolution of the Czech Supreme Administrative Court of 27 January 2010, File No. 2 As 64/2009.

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specific funds. However, the above facts create somewhat different conditions for bank guarantees, which follow especially from the legal regulations and the related requirement made by the given entity, where the latter generally defines the conditions for issuing a bank guarantee to secure the performance of the debtor's obligation. The above facts have a significant impact on the process of formulating the contents of the guarantee deed and the process of issuing the deed as such.

Persons authorised to issue a bank guarantee

The Civil Code regulates bank guarantees in Sections 2029 to 2039. These provisions actually govern the concept of "financial guarantees", as the Civil Code allows a wider range of issuers than just banks to issue a guarantee. Where the issuer of a financial guarantee is a bank, foreign bank or credit union, the instrument in question is deemed to be a bank guarantee.

Pursuant to Act No. 21/1992 Coll., on banks, banks are joint-stock companies with their registered office in the Czech Republic which

a) accept deposits from the public; and
b) provide credits and loans;

and which hold a bank licence for the activities under subparagraphs a) and b).

Banking activities may also be carried out by foreign banks in the Czech Republic via a branch. A foreign bank:

a) with its registered office in a Member State of the European Union or in a country that is a party to the Agreement on the European Economic Area enjoying the benefits of a single licence under the European Union law (Section 5a) performs these activities through its branch;
b) with its registered office in a country other than a Member State performs these activities through its branch if it has been granted a licence by the Czech National Bank and only within the scope of the licence granted.

A bank licence contains a nominal definition of the permitted activity and may include specification of the scope of the permitted activity, but not in the sense of limitation of the number of individual business cases, and may also include specification of the conditions that the bank or the branch of a bank from an EU non-Member State must meet prior to the commencement of any permitted activity or comply with in the performance of any permitted activity.

Savings co-operatives and credit unions operate pursuant to Act No. 87/1995 Coll., on savings co-operatives and credit unions and certain related measures and supplementing Czech National Council Act No. 586/1992 Coll., on income taxes, as amended. The Czech National Bank will grant a licence to operate as a credit union (a "licence") to a co-operative with its registered office in the Czech Republic which aims to carry out the following activities

a) acceptance of deposits from its members; and
b) provision of loans to its members.

The business name of a credit union must include the designation *"spořitelní a úvěrní družstvo"*, *"družstevní záložna"*, *"spořitelní družstvo" or "úvěrní družstvo"*; only a legal entity established

under the Act may use this designation. A credit union is not a bank under the law governing banks, and its business is not considered a trade. Credit unions may issue bank guarantees only for its members.

Origination of a bank guarantee and guarantee deed

Suretyship under a bank guarantee arises with the issuance of a "guarantee deed". A bank guarantee is created through the issuer's (bank's) declaration in the guarantee deed that the issuer will satisfy the creditor according to the deed up to a certain pecuniary amount if the debtor fails to discharge a certain debt to the creditor or if other conditions specified in the guarantee deed are met. Such a condition may consist, for example, in the presentation of certain documents. A guarantee deed must be made in writing.

It may be issued in paper form or in the form of an electronic document. The requirement for written form is also deemed to be met in juridical acts made by electronic or other technical means which enable their contents to be captured and the acting person to be identified. An electronic bank guarantee is therefore a bank guarantee in electronic form (e.g. in the PDF format) with recognised electronic signatures attached on behalf of the bank.

This is a unilateral juridical act carried out by the issuer of the guarantee deed. Section 2029 of the Civil Code does not expressly lay down the same condition as set out in Section 2018 of the Civil Code with regard to suretyship, i.e. "if the creditor does not accept the surety, the former cannot demand anything from latter"; nonetheless, this rule also applies to suretyship provided in the form of a guarantee. A guarantee deed also identifies the creditor to whom the bank guarantee is being issued.

The deed must contain a declaration comprising the issuer's obligation to satisfy the designated creditor. This will always be an obligation to provide pecuniary performance (in money). Based on the guarantee, the issuer is not required to pay the debt in any way other than in money.

Each guarantee deed must include specification of the debtor's debt that is being secured. This will usually be done by identifying the debtor and quantifying his debt towards the creditor. The debt may arise from a contract, a unilateral juridical act (e.g. a public promise or indemnity) or another legal cause (obligation to provide a security deposit, etc.).

A bank guarantee may serve to secure both a pecuniary claim and a non-pecuniary claim (a claim in kind). Where a non-pecuniary claim is being secured, it is deemed that the security covers a pecuniary debt up to the amount of the creditor's claim arising in case of default with the secured obligation.

Pursuant to Section 2029 of the Civil Code, the issuer stands surety for the performance of the secured obligation up to the amount specified in the guarantee deed. It follows that the amount must be specified in the guarantee deed. If this condition is not met, the bank guarantee will not be considered valid. The result, however, could be treated as simple suretyship.

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A guarantee deed sets out the conditions under which the issuer is required to pay a particular debt to the creditor. The specification of these conditions also predetermines the nature of the guarantee in terms of its accessory and subsidiary nature.

The guarantor's obligation is legally autonomous and is only dependent on the existence of the secured obligation if this is apparent from the content of the guarantee deed. If no conditions are set out in the guarantee deed, the issuer has to perform his obligation on the creditor's call without further ado.

A guarantee deed is not considered a security instrument in which the claim ensuing from the bank guarantee is incorporated. The guarantee deed need not be presented to enforce the claim arising from the bank guarantee, and the guarantee terminates in the set manner regardless of whether or not the guarantee deed has been returned to the bank. Loss or destruction of a guarantee deed does not invalidate the related bank guarantee. The rights under a bank guarantee can be transferred by a claim assignment agreement; an endorsement made on the guarantee deed does not suffice in this regard.

It is quite common in practice that a guarantee deed specifies the term for which the given bank guarantee is provided. A bank guarantee may be agreed and issued for a fixed term or for an indefinite term. The term may be defined by specifying a certain deadline, but also by indicating the time when a certain period of time starts. In that case, the claim ensuing from the bank guarantee cannot be exercised before the time set out in the deed.

If a guarantee were to be subsidiary in nature, this would also have to be explicitly laid down in the guarantee deed. According to the guarantee deed, the creditor would first have to call on the debtor to perform and, only if this failed, could the issuer be called on to pay the debt.

However, bank guarantees are often unconditional in practice, i.e. they are neither accessory nor subsidiary. The issuer of a bank guarantee may not simply assert against the creditor any objections whatsoever that could otherwise be asserted by the debtor; any potential objections must be set out in the guarantee deed.

Unless otherwise stated in the guarantee deed, the issuer has to pay the secured debt even if it has already terminated, if the creditor's claim has become time-barred or if the creditor has not provided the debtor with the performance agreed in their contract or has not provided the debtor with the co-operation necessary for payment of the debt, etc. The issuer who issued (or confirmed) the given financial guarantee is therefore entitled and obliged to examine, before paying the debt, only those facts to which the guarantee deed links the payment. If payment under a guarantee is requested in accordance with the guarantee deed, the issuer cannot refuse such payment on the grounds that the debtor is not obliged to pay the secured debt to the creditor.[2]

Where the "formal principle" applies, i.e. where the issuer's obligation to satisfy the creditor from the guarantee is bound only to the creditor's declaration with a content precisely defined

[2] Judgement of the Superior Court in Prague 5 Cmo 265/2006.

in the guarantee deed (e.g. the creditor's declaration that the debtor has not paid his due debt), the issuer is not entitled to examine the truthfulness of such a declaration.[3]

The creditor may assign his right to payment under a bank guarantee to other parties**.** This is conditional on the previous exercise of the right to payment under the bank guarantee. The guarantee deed may also allow the creditor to assign the right to exercise the bank guarantee. An assignment of the right to exercise the bank guarantee also transfers the right to payment under the bank guarantee.

Legal relationship between the issuer and the debtor

The mutual relationship between the bank and the debtor is also important – along with the relationship between the bank and the beneficiary – for the obligation under the bank guarantee. In practice, this relationship is always regulated by a bank guarantee agreement or other agreements.

While the bank guarantee agreement, to be concluded between the debtor and the issuer of the bank guarantee, is foreseen by the new Civil Code as such (Section 2039 of the Civil Code), the contents of this agreement are not defined. A third party other than the debtor may also enter into a bank guarantee agreement with the issuer.

In particular, the agreement between the issuer and the debtor will indicate what facts are decisive for the issue of the guarantee, i.e. the guarantee deed. This will include primarily specification of the obligation being secured, the creditor, the nature of the bank guarantee (conditional or unconditional), the term of its validity, the amount of the guarantee, any objections against the creditor, the content of documents necessary for the exercise of the claim, the conditions for modifying and terminating the guarantee, etc.

In the bank's decision-making on whether or not a bank guarantee will be provided, the debtor and the claim being secured are treated as if a loan were to be granted, because a bank guarantee is a potential loan for the bank. In this context, the bank issuing the bank guarantee may require that a security be arranged for the possible future claim should the bank be required to pay under the guarantee. This may take the form, e.g., of a mortgage or pledge, or funds deposited in a current or deposit account, with the bank's right to collect these funds in order to pay its due claim following from the bank guarantee.

The debtor is obliged to compensate the issuer for anything that the latter has paid under a guarantee deed issued in accordance with the concluded contract. This obligation also applies to a third party who has entered into a bank guarantee agreement with the issuer. The debtor may not raise, against the issuer of a bank guarantee, objections that could be raised against the creditor unless the debtor has agreed with the issuer that such objections will be reserved in the guarantee deed. Hence, only such objections may be raised as were intended to be raised by the issuer against the creditor in the bank guarantee agreement.

[3] Judgment of the Czech Supreme Court 32 Cdo 4725/2014.

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Bank guarantees are provided for a fee. In practice, this takes the form of a "commitment fee" (e.g. starting at 1% p.a. of the value of the guarantee + risk premium; at least CZK 2,000 in aggregate). The amount of the risk premium in the commitment fee is influenced mainly by the internal rating of the applicant (client) in the bank's records, the type of bank guarantee and the method of securing the guarantee obligation.

The bank usually also charges further fees related to the processing and execution of the business case and other bank's obligations arising from the guarantee. The client also bears the costs of other entities in the case of super guarantees or counter guarantees issued by other banks.

If the bank satisfies the creditor from a guarantee provided in accordance with the mutual agreement, the debtor has to reimburse the bank for what the bank has paid on his behalf (Section 2039 (1) of the Civil Code). Unlike in the case of suretyship, the legislature did not vest the bank with the right of subrogation. Subrogation refers to a change of the creditor once a third party pays the debt to the original creditor in place of the debtor. This puts the third party in the creditor's position and the debtor then has to pay to the former, because the original creditor's claim expires and the claim is transferred to the new creditor. The law provides only the right of recourse against the debtor for whose benefit the payment under the guarantee was made. This affects, in particular, the scope of the rights vested in the creditor exercising the recourse.

In case a bank provides a bank guarantee in contradiction with the relevant agreement, the bank may only exercise its rights against the debtor within the scope in which the guarantee deed should have been issued. The same applies if the deed was issued correctly but the creditor's claim was satisfied in a way contradicting its contents.

The debtor may have a claim for damages against the bank on the grounds of the bank's breach of the bank guarantee agreement.

Confirmation of a bank guarantee or its notification by another issuer

A bank guarantee issued by a particular bank may also serve to secure an obligation ensuing from a bank guarantee originating from another bank. This is called a "super guarantee" and is used mainly in international trade. A bank guarantee provided to the creditor by a lesser-known bank is thus secured vis-à-vis the creditor through a guarantee provided by a more renowned bank. Payment under this bank guarantee is usually also conditional on non-compliance with the obligation under the secured bank guarantee. If such a condition is not set out in the guarantee deed, the creditor may file a claim against any of these banks.

A "counter guarantee" is also used in international trade. In this case, the debtor asks his bank to provide a bank guarantee by sending the guarantee deed to the creditor's bank. The bank then issues its own bank guarantee to the creditor. It is crucial that both guarantee deeds have identical contents.

Pursuant to Section 2031 of the Civil Code, if a bank guarantee is confirmed by another bank, the creditor may assert claims under the guarantee against any one of these issuers. If the issuer

who has confirmed the guarantee has paid on its basis, this issuer has the right to claim such payment from the issuer who asked for the confirmation.

A different situation arises if the issuance of a bank guarantee by the issuer is notified (announced) to the creditor by an issuer other than the issuer obligated under the guarantee. The issuer is not bound by the notification under the bank guarantee; however, if the issuer has caused any damage by his notification, he has to compensate for such damage. The significance of such notification for the creditor lies primarily in the confirmation of the very existence of the issuer who issued the guarantee, as well as in the assurance that the obligation under the guarantee has indeed validly arisen. It is clear from this point of view that the announcing issuer must be in possession of the guarantee deed so that he can assess the content and details of its issue.

Legal relationship between the creditor and the debtor

The securing function of a bank guarantee, regardless of its legal nature, is manifested in the fact that the issuer's payment causes the debtor's obligation to the creditor to terminate. In principle, neither the debtor's call for performance nor his consent to performance is required for the issuer's payment. The guarantee may be more or less abstract, depending on the wording of the guarantee deed. However, the guarantee deed may indicate an obligation for the creditor to first call on the debtor to pay or to prove that the debtor is unwilling or unable to perform the obligation.

The inception of the obligation to pay on the basis of the suretyship created by the bank guarantee is subject to the conditions set out in the guarantee deed. The issuer of a bank guarantee must perform the obligation under the bank guarantee provided that he is called on to do so by the creditor in writing (Section 2035 of the Civil Code). If the guarantee deed makes the issuer's payment conditional on the submission of a particular document, such a document must be submitted on request or without undue delay thereafter, but always during the term of the bank guarantee.

Where it is not specified when the bank guarantee becomes enforceable, this occurs at the time when the secured obligation falls due. In order to meet the given time limit, it is sufficient if the creditor notifies the bank of its claims under the bank guarantee in writing while the guarantee is still valid. In such a case, the bank will perform its obligation under the guarantee on the basis of a timely call, but after the guarantee has expired. The bank's obligation to perform under the bank guarantee may also be subjected in the guarantee deed to the fulfilment of other conditions.

It follows from Section 2037 of the Civil Code that if the issuer is obliged to pay under the guarantee deed for the entitled party's benefit to another issuer, the former is required to make the payment into the entitled party's account maintained by the issuer. According to literature, this legal regulation covers, in particular, those situations where the guarantee deed is sent to the creditor bank and the guarantor bank undertakes to pay to the former for the creditor's benefit.

If, on the basis of a guarantee, the creditor receives a payment to which he is not entitled within his relationship with the debtor, the debtor will be entitled to demand that the payment be

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refunded to him. This situation arises when an abstract bank guarantee is misused. This will be true, in particular, in cases where the creditor has received payment under the bank guarantee even though the debtor has performed his obligation or where the right to payment under the bank guarantee has not arisen. The debtor's right to a refund corresponds to the creditor's obligation to return the payment under the guarantee.

In its earlier case law, the Czech Supreme Court held that one of the conditions for the debtor's right to a refund of payment from the beneficiary was the debtor's prior settlement with the bank that paid under the bank guarantee. However, such a settlement was not feasible, for example, in cases where insolvency proceedings were conducted against the debtor.

Recent case law[4] suggests a different interpretation. The legal relationship between the debtor and the beneficiary, on the one hand, and the legal relationship between the debtor and the issuer, on the other hand, are treated as two independent legal relationships arising on different legal grounds. Hence, the debtor's entitlement to demand from the beneficiary a refund of the payment which the latter has wrongfully obtained under a bank guarantee to the debtor's detriment is not conditional on the debtor's prior reimbursement of the payment to the bank, as the issuer of the bank guarantee.

Termination of the obligation under a bank guarantee

A bank guarantee terminates upon lapse of the term for which it was issued unless the creditor notifies the bank in writing of its claims under the bank guarantee during its term. However, if a payment is made before the lapse of the specified time, the bank guarantee will terminate before the expiry of the set term by virtue of its performance. The same applies if the bank performs the obligation without there being any time limit for the exercise of the bank guarantee.

The issuer's obligation under the guarantee may, of course, also terminate through all other general methods of extinguishment, in particular through agreements of various kinds, such as an agreement on cancellation, novation, settlement, waiver, merger of the creditor and the bank, or of the creditor and the debtor, etc.

In the case of a conditional bank guarantee, the bank guarantee will also terminate once the debtor performs his obligation.

It would be contrary to the nature of a bank guarantee if the bank had the option to revoke it. This option might only be allowed in cases where the bank has expressly reserved the right of revocation under conditions set out in the guarantee deed. A mere termination of the bank guarantee agreement between the debtor and the bank cannot result in the revocation of a bank guarantee which has already been issued in the form of a guarantee deed.

CONCLUSION

The provisions on bank guarantees in Czech law have their tradition and form a solid part of modern legal regulation. For many debtors, a bank guarantee represents a very effective way

[4] Judgment of the Czech Supreme Court 31 Cdo 3936/2016.

of securing their transactions, and also enables them to establish new business relationships. The relative simplicity of the legal regulation and the reliability of the banking sector allow for an expansion of bank guarantees not only in domestic, but also in foreign trade.

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