The Law Governing Unconditional (First demand- Independent) Bank Guarantees in Ethiopia

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This is to certify that the thesis prepared by Yared Siyum Nigussie, entitled: "*The law Governing Unconditional (First Demand- Independent) Guarantees in Ethiopia"* and submitted in partial fulfillment of the requirements for the degree of Masters (LLM Business Law) complies with the regulations of the university and meets the accepted standards with respect to originality and quality.

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This research is dedicated to my mother, Meselech Gebre Egzeabher.

Acronyms

Civil Code- Civil Code of the Empire of Ethiopia Proclamation No. 165 of 1960

Civil Procedure Code- the Civil Procedure Code Decree no 52 of 1965

Commercial Code- Commercial Code of the Empire of Ethiopia, Proclamation no 166 of 1960

FDG – First Demand Guarantee

ICC- International Chamber of Commerce

ISP- International Standby Practices (ISP98) ICC Publication No. 590

National Bank- National Bank of Ethiopia

UNICITRAL- UNICITRAL Convention on Independent Guarantees and Stand-By letters of Credit

URDG – Uniform Rules for Demand Guarantees (URDG) ICC Publication No. 758) (2nd Revised Edition 2010)

The Law Governing Unconditional (First demand- Independent) Bank Guarantees in Ethiopia

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Abstract

This research is essentially focused on the existence of a legal basis for what is called First Demand (independent) Guarantee and the applicability of relevant laws thereto. Thus, in achieving this end, legal and case analysis are principally used.

Often times, within transactions the risk of non-payment or non-performance is always there. To avoid or, at least, to minimize this risk guarantee is a preferred tool. Nonetheless, the conventional guarantee concept which is subject to various defenses and conditions before payment is perceived to be ineffective and time-consuming. Since such traditional guarantee is an accessory one, it is prone to rigorous court litigation. This leads creditors to lose the real-time value of money. In today's Ethiopia, the need to use for the first demand (independent) type of guarantee is growing faster both in public and private procurements.

This research is a modest attempt at discussing the need to have an adequate legal framework along with proper demarcation of the judiciary's role. Moreover, the research indicates the usage of the power of foreclosure sale against collaterals employed during the issuance of FDGs by the banks while there is no legal right to this effect, as the Property Mortgaged or Pledged with Banks Proclamation's scope of application is limited to loan reimbursement and yet issuing guarantee is not recognized as a loan under the law. Finally, this study underlines the need to make some legal development in addressing the problem.

1. Introduction

There are several reasons to employ guarantees, for the existence of healthy contractual relations among different actors in trade. Midst others, some particular dealings, like that of international, government bids, procurement contracts etc. are often entered between persons who do not know each other and at times without even having the opportunity, for parties or their agents to meet in person. This may create complexity. Furthermore, contracts at times involve a number of parties. Besides to this inevitable nature of contracts, the boundary between countries is getting eroded in terms of economic transactions due to globalization in general and communication (the transport and electronic) advancements, in particular. Consequently, the progress in terms of type and coverage of guarantees or securities becomes a priority. A writer emphasized this circumstance, in international trade; risk is becoming a factor of increasing significance and concern. Transactions tend to grow and investments in projects are becoming larger. Projects nowadays are often complex, comprehensive and large-scale.[1]

The conventional guarantee or surety, under which prior to the effect of payment, the guarantor may raise various defenses, as stated under the Civil Code, the guarantor may set up against the creditor all the defenses available to the debtor, and the fact that the principal debtor might have waived them cannot be set up against him.[2] Likewise practically speaking, there are lots of pending and resolved court cases involving financial guarantees, and in most cases; the point in issue is which party breached its duty first.[3] These court cases eventually took years before they finally get decided by the higher level courts. Some of the cases passed through, four stages i.e. all the three levels of federal courts and cassation bench of the federal supreme court.[4]

In order to avoid these drawbacks, the independent guarantee is invented by legal engineers; this guarantee is anticipated to be issued by reliable and financially sound institutions such as banks. This operates in much the same way as documentary credits (or letters of credits)[5]

For the reasons stated above, creditors to contracts nowadays prefer to adopt first demand or 'unconditional guarantees', often to be issued by commercial banks. While parties prefer this

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[1] Roeland V. F. Bertrams, *Bank Guarantees in International Trade the Law and Practice of Independent (first demand) Guarantees and standby Letter of Credits in Civil Law and Common Law Jurisdictions* (third revised edition 2004) 2

[2] *Civil code of the Empire of Ethiopia*, 1960, Book IV Title XII, article 1926

[3] Interview with *Ashenafi Lemecha,* Associate Judge, the FDRE High court (Addis Ababa, Ethiopia 11 April 2016)

[4] ibid

[5] Roeland (n 2) 2

type of guarantee they both assume the beneficiary of the instrument or the creditor with a high degree of 'certainty' will avoid the risk of non-payment and delivery. The principle, what is called, 'pay first argue latter'[6] is enshrined. However, in practice, while debtors default and beneficiary creditor claim payment accordingly, as is usual debtors lodge files before the court of law and the courts assume full jurisdiction over the matter and pass temporary injunction as provided for in the Civil Procedure Code. This makes the 'unconditional', independent guarantee lose its nature to become conditional and accessory. Further, the uncertainty of transactions may arise due to such instances. This guarantee has its own various peculiar features; such particularities are discussed in chapter two of this paper.

Regarding the nomenclature of this particular guarantee instrument, various literature suggests the term 'unconditional' be misleading, while at least a call or demand is expected as a condition by the bank's side to effect payment, naming such instrument as 'Unconditional' is not preferable. In contrast, terms like that of 'first-demand' and 'independent' are found to be much precise.[7] Consequently, the title of this study adhered to such development. Some legislation introduced such guarantee type and this could be taken as a legal basis for the Ethiopian legal system. Save such legislations are at a relatively lower hierarchy, i.e. Directives compared to the Civil Code and those in a similar status to the Civil Code are general laws to guarantee. Moreover, various issues remain unanswered yet and this paper will endeavor to identify such and suggest the possible solutions.

2. Statement of the problem

Comparable to any other contract; the general provisions of the Ethiopian Civil Code are applicable for FDGs as well. Predominantly while we examine the applicability of the Ethiopian contract law, provisions running from articles1920, and the following are claimed to be relevant. The nature of these provisions acknowledges the conventional guarantee type and look as if inconsistent with what is called an 'unconditional' guarantee, i.e. guarantee payable upon first demand, under which the beneficiary is entitled to receive payment from the bank without any proof of corroboration of the principal debtor's default.[8]As an illustration, we may look at some of the relevant provisions of the civil code. Under article 1924(1), it is stated that a guarantee may not be contracted in more burdensome terms than those in the main contract. Whereas under the first demand bank guarantee,[9] the guarantor is expected to assume ***more***

[6] Ibid this principle is examined under chapter two.
[7] ibid
[8] Roeland (n 2) 3
[9] See chapter two for the conceptual underpinnings of this guarantee type.

burdensome terms as it is expected to forgo one's benefit of discussion,[10] due to the nature of the instrument, to pay the guarantee amount without whatsoever possible defense available and latter to raise the defenses after payment.

Furthermore, the declaration of the existence of default (if the affirming of default is indispensable under the particular guarantee) is left for only to the creditor guaranteed under the FDG and not subject to dispute until payment of the guarantee, with the exception to the existence of fraud. Whereas, the Civil Code provisions particularly, the reading of articles 1933 and 1934 presupposes the existence of a default and the proof of it as a precondition.[11]

On the other hand, some lawyers in banks[12] tend to raise the principle of freedom of contract as a justification. Since *parties are free to agree to create, vary or extinguish obligations of a proprietary nature*, [13] and the law further ensures enforceability of contracts, *the provisions of a contract lawfully formed shall be binding on the parties as though they were law.*[14] As a result of such provisions, unless the object of a contract is unlawful or immoral[15] or other mandatory provisions are not derogated such as form requirements, the judiciary shall ensure enforcement of contracts. This argument further raises the private nature of Law of contract[16] under which the extent of the existence of public interest is less and the state shall be limited to a minimalist approach, with the exception of balancing differences of bargaining power for various reasons.[17]

The other issue towards first demand bank guarantee is unlike other possible gratuitous guarantees,[18] it will create a dual contractual relationship, i.e. the contract between the

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[10] Civil Code (n 2), article 1935 and 1926 (2)

[11] See for instance article 1933 of the civil code, "where the person undertaking the guarantee described himself as joint guarantor, co-debtor, or used equivalent terms, the creditor may sue him without previously demanding payment from the debtor or realizing his securities." Under this scenario the law requires existence of default and if the guarantor declined to pay the agreed sum the possible defense of the guarantor is non-existence of default, among others. While we see 1934 "a guarantor shall not pay the creditor unless the principal debtor fails to discharge" under this latter situation the creditor needs to prove default and claim is made earlier for the debtor.

[12]Interview with *Mandefro Mihrete*, A/Manager Legal Services and *Tseada Fantahun*, Senior Attorney Commercial Bank of Ethiopia (Addis Ababa, Ethiopia 7 April 2016)

[13]Civil Code (n 2), article 1675

[14]Ibid, article1731 (1)

[15]Ibid, article 1716

[16] Interview with Mandefro (n 12)

[17] See for instance article 1710 (2) of the civil code, *"Where justice requires, any such contract may be invalidated as unconscionable where the consent of the injured party was obtained by taking advantage of his want simplicity of mind, senility or* ***manifest of business inexperience****."*

[18] See Tilahun Teshome, *Basic Principles of Ethiopian Contract Law*, (Addis Ababa University Book center) 2007 246 - 247 and Civil code (n 2), article 1921

guarantor bank and the creditor by the one side and the debtor guaranteed with the first demand guarantee and the bank issuing the bond (mandate contract). The major legal problems with the former contract are dealt above. The latter relationship is often secured with mortgage and the accompanying issue is once demand of the creditor is forwarded to the guarantor bank and payment of the agreed sum within the maximum amount stipulated on the instrument is made, may the banks foreclose the security they accept for the issuance of the guarantee, following the procedures stated in the foreclosure proclamation.[19]

Since the preamble of Property mortgaged or pledged with Banks proclamation explicitly stated, the need to enact the proclamation is to ensure accelerated recovery of loans.[20] Not only the preamble but also article 3 of the proclamation further stipulated another precondition, i.e. a bank *whose claim is not paid within the time stipulated in the contract*, in view of that the applicability of foreclosure sale for security provided in purchasing FDG is a decisive concern. Moreover, since the claim of the bank is anticipated to be associated with 'loan' under the foreclosure proclamation and the definition of loan is not given therein, we need to refer to the Civil Code, *The loan of money and other fungibles is a contract whereby a party, the lender, undertakes to deliver to the other party, the borrower, a certain quantity of money or other fungible things and to transfer to him the ownership thereof on the condition that the borrower will return to him as much of the same kind and quality*.[21] As a result of such definition the concerns to be addressed are; can the security provided by debtors directly fit into the definition of the law, if not what another alternative may the banks legally adopt.

3. Research questions

1- Is the notion of first demand bank guarantee compatible with the existing contract law of Ethiopia?
2- Is there any other legal mechanism to govern such a particular matter in today's Ethiopia or is the subject matter left for surety provisions and /or freedom of contract of parties?
3- What would be the effect/s of applying the suretyship provisions of the Civil Code in regard to independent bank guarantees as things stand today?
4- If first demand bank guarantee is enforceable under Ethiopian law, does court's power to give temporary injunction extend to such instrument?

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[19] *Property Mortgaged or Pledged with Banks Proclamation* No. 97/1998

[20] *WHEREAS, consequently, banking business thriving on interest payments on loans it provides from public money received by way of saving deposits or acquired from othersources, has been adversely* affected Ibid, preamble second paragraph

[21] Civil Code (n 2), article 2471

5- May the banks extend the foreclosure procedures in case debtors guaranteed by such guarantee default and the banks secured their interest with real property?

4. Methodology

Based on the above and other related research questions; this research is a mixed one in its type, combining both doctrinal and empirical methods. Since its hypothesis extends to the search for the existence of governing law towards the notion of first demand bank guarantee, the applicability of the Civil Code provisions dealing with surety and the effect of the application of the Civil Code, these aspects of the problem leads to a doctrinal approach.

Whereas, the issues of injunction and foreclosure vis-à-vis first demand bank guarantee require case studies and further examining the understanding of the judiciary and other relevant practitioners' as-well. Consequently, employing empirical approach was not a matter of choice. The research problem is not yet studied in the context of Ethiopian legal system, to the extent of the researcher's quest. Owing to this reason, this research relied on primary data collected by the researcher with the exception of corroborative literature. Among others, the following are employed, various relevant legislation, court cases (cases from Federal Courts) and structured and semi-structured interviews. The data analysis technique used for this study is a qualitative one in a way which enables to explain the effect of the existing law towards FDG and the current practice of the judiciary vis-à-vis the substantive and procedural law.

5. Scope of the study

In its scope, the research is limited to the examination of the status of FDG under the Ethiopian law. The likely role of Federal courts (among the federal courts, relevant benches of courts which situate in Addis Ababa are considered) in the enforcement of such instrument and lastly the effect of default of the debtor, later on, the collaterals used during the process of issuance of FDG is studied.

6. Objectives and Significance of the study

The issue of guarantee, by and large, is very decisive in economic transactions. There are various reasons which compel parties to use guarantee, to reduce the complexity of business relation, in combating unwanted effects of relationships and in minimizing the risk of nonpayment or delivery. This decisiveness is mainly the basic rational to pick the topic for study.

However, various actors claim for the inefficiency of the traditional accessory guarantee for the achievement of the intended purpose of guarantees. Taking this reality as a springboard this research paper endeavored to examine the acceptability and applicability of this latest development i.e. first-demand independent bank guarantee, under the Ethiopian law,

specifically under federal government's jurisdiction, through raising theoretical and practical discourses.

The paper considered the extent of judicial involvement and its acceptability as well. Further, since enforcement of guarantees under ordinary circumstance anticipates default the possibility of court litigations surrounding FDG is expected. Hence, by identifying the status of first demand guarantee this research may assist the legislator, judiciary, banks, creditors, debtors and other stakeholders to consider their action as the case requires.

7. Limitation of the study

During the process of conducting this thesis, the researcher faces the following major limitations. Unavailability of variety and timely literature, poor archive collection for earlier legislation, lack of willingness and cooperation from some potential interviewees (in this regard it is important to mention some of the Cassation Division judges) and last but not least the haphazard court's dead file handling procedure consumed much time in identifying relevant cases to the study.

Chapter Two

Conceptual Underpinnings of First Demand Guarantee

2.1. **Guarantee in General**

In general, guarantee is defined as an undertaking or promise whereby one person (**c**alled the guarantor or surety) agrees to be answerable for the payment of a debt or the performance of some act by another person who must be legally bound to pay the debt.[22]

Guarantees are forms of security. The security is provided by a third party in a typical arrangement.[23] After some initial confusion, Continental law now reserves the term guarantee for the concept of independent guarantee, while the term surety-ship refers to the accessory type. One may safely assume that major transactions today do not take place without some kind of guarantee support.[24]

A transaction of guaranty involves at least three parties: a promisor, a creditor (the person to whom the promise is made), and a debtor - although at the time the promise is made, the person denominated the 'creditor' need not have extended the credit to the person denominated as the 'debtor.' The usual guaranty situation arises when the promisor makes a promise to the creditor either as to the solvency of the debtor or as to the payment of the debt or both.[25]

2.2. **First Demand Guarantee**

It is any signed undertaking, however, named or described, providing for payment on presentation of a complying demand.[26] As a type of guarantee, First Demand Guarantee (FDG) shares the basic features of guarantee, since it is an instrument for payment of debt. Though, FDG shares this basic feature of guarantee it has its own important and peculiar features as well.

This guarantee is often to be issued by banks. It can be defined as a contract or a document whereby the issuer (guarantor), upon the request of the applicant (principal), is committed against the beneficiary (guaranteed side) that on demand or at a certain maturity, without any stipulation to pay a certain amount of cash for a specific issue which is related to the beneficiary

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[22] L. C. Mather, *Guarantees and the Banker* (University of London, Kings College 1961) 2

[23] Fenwick Elliott, '*Bonds and Guarantees'* (2011)<www.fenwickelliott.com> 21May 2016

[24] Roeland Bertrams, *Bank Guarantees in International Trade, The Law and Practice of Independent (First Demand) Guarantees and Standby Letters of Credit in Civil Law and Common Law Jurisdictions* (third revised edition 2004 ICC publishing S.A Paris – New York, KLUER LAW INTERNATIONAL) 1

[25] Thomson Reuters, *'American Jurisprudence' in Cumulative Supplement* (eds) (1968) 996

[26] *Uniform Demand Guarantees Rules* (URDG 758) 2010 ICC publication, article 2

or to the order of him/her.[27] Under the latter subsections, an attempt will be made to enumerate and discuss some of these distinctive features.

2.2.1. Function

FDGs have several functions, which vary depending on the point of reference. Their paramount function is the furnishing of security for either financial obligations, namely payment of agreed amounts, or nonfinancial obligations, namely payment of damages. This purpose is achieved by assuring the creditor/ beneficiary financial compensation in the event of default by the principal debtor/ account party, to remedy the consequences of the breach of contract.[28] It has liquidity (or 'cash' or 'prompt') function.[29]

Having the above stated major functions of FDG in mind, the beneficiary of an FDG receives immediate payment when he is of the opinion that the principal debtor defaulted, without the need of having to establish his case first and regardless of the account party's objections.[30] It is the precise purpose of a first demand guarantee to put the beneficiary in possession of the funds pending the final resolution of their dispute.[31] What matters is the actual and immediate possession of compensation. This wisdom is reflected in the time-honored expression 'the law is where the money is'.[32]

In the case of a dispute between the parties to the underlying transaction, payment of damages shall be made by the guarantor on behalf of the account party to the beneficiary without any evidence of default, and that after such payment the parties may negotiate or litigate the question of final indebtedness if any.[33]

At any rate, contentions by a principal debtor/ account party that a first demand guarantee should not be enforced because of its unfairness, because of unequal bargaining powers or because it has been exacted by means of undue influence are to be dismissed.[34] The prime

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[27] DR Homayoun Mafi and Mahdi Rahmani, '*Analysis of Legal Nature of Bank Guarantees in Iranian Law'* (2013) 1 International Journal of Scientific research <http://www.worldwidejournals.com> accessed July 12 2016

[28] Roeland (n 3) 13

[29] Ibid 14

[30] This paper is basically founded on this nature of FDG and its examination in line with the Ethiopian laws.

[31] Roeland (n 3) 14

[32] Ibid 72

[33] KrÖll S Rechtsfragen, '*Elektronischer Bankgarantien*,'[2001] P 1567 as Cited on Roeland, (n 3) 73

[34] Roeland (n 3) 81 this is among other issues to be considered vis-à-vis the provisions of the Civil Code see articles from 1696 and 1710 (2)

function of first demand guarantees is to secure performance, rather than to secure financial compensation for non-performance.

2.2.2. Reallocation of Risks

FDG brings about a complete reallocation of risks, with the beneficiary enjoying a very strong and advantageous position and the account party occupying a correspondingly week and disadvantageous position.[35]

FDGs reallocate risk from the creditor to the principal debtor by virtue of an agreement. This reallocation is fittingly conveyed in the universally adopted expression 'pay first, argue later'.[36] After payment, it is the principal debtor (account party) who encounters the formidable risks and difficulties attending the realization of a claim for repayment.[37] As a result, a creditor waiting for delivery or payment backed by FDG may with a higher degree of certainty assure to compensate for failure in delivery or payment.

Afterwards, the two possible grounds for the account party to institute an action before a court of law or an arbitration panel, as provided in the principal contract, if he is of the opinion that he was not in default or that the actual loss sustained by the beneficiary was less than the amount paid under the guarantee.

2.2.3. Commonly Used Types of First Demand Guarantees

2.2.3.1. Tender Guarantees (bid bond) the purpose of tender guarantee is to ensure that a bidder does not withdraw or alter his tender before adjudication and that he will accept and sign the contract if and when awarded to him, usually from 1 to 5 percent.[38]

2.2.3.2. Performance Guarantees assures payment to the employer in the event that the contractor has not timely, not completely or not properly fulfilled his obligations from the underlying contract, and usually ranges from five to ten percent.[39]

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[35] Ibid 51
[36] Ibid 73
[37] John F Dolan, *The Law of Letters of Credit (Commercial and Standby Credits*, 1996 32
[38] Roeland (n 3) 38
[39] Ibid 39

2.2.3.3. Maintenance (or retention or warranty) Guarantees ensure that exporter or construction firm remedies any defects which become apparent after delivery of the goods or after provisional or substantial completion of the plant.[40]

2.2.3.4. Repayment or Advance Payment Guarantees in most major contracts the exporter or contractor negotiate for advance payments, which ordinarily range from five to thirty percent of the contract value, in order to be able to finance the transaction, especially in the initial phase of execution. In turn, the employer will require a repayment (advance payment) guarantee.[41]

2.3. **The Need and Justification behind First Demand Guarantee**

Independent guarantees are a relatively new legal phenomenon. It seems that they first appeared in the American domestic market sometime in the mid-1960,[42] while according to bankers they began to be used in some appreciable measure in respect of international transactions during the early 1970s.[43]

The device of guarantee payable on first demand originates from the former practice of exporters and contractors having to place a cash deposit (or 'earnest' money) which could immediately be seized by the importer or the employer in the event of default. This technique was found cumbersome. It necessitated exporters and contractors raising funds which remained tied up for a considerable period of time, and this adversely affected their liquidity position, 'legal engineers' then conceived the idea of first demand guarantees as a substitute for cash deposits, thus avoiding this disadvantage while preserving the favorable position of the importer or employer.[44]

It could be strange to consider this guarantee instrument as new in today's speed of dynamism of the world's order, after all, these 50 years of development. However, one may justify the novelty of this alternative guarantee instrument looking into some historical facts, among others; the Old Testament of the Christian's holy book is inclusive of various verses indicative of surety-ship back long ago i.e. believed to be more than 2000 years.[45]

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[40] Ibid 40
[41] Ibid 41
[42] H Harfield, *Bank Credits and Acceptances* (fifth edition 1974 New York) 251
[43] Roeland (n 3) 1
[44] Ibid 53
[45] See for instance Proverbs chap 6: (1 & 2*) My son, if thou be surety for thy friend, [if] thou hast stricken thy hand with a stranger, thou art snared with the words of thy mouth, thou art taken with the words of thy mouth. And 11:15 he that is surety for a stranger shall smart [for it]: and that hateth surety-ship is sure.*

Banks have a preference on this type of guarantee because, under the traditional surety-ship, if a bank were to act as a surety, it would have to assess the chances that the principal debtor will default and, secondly, after undertaking the secondary guarantee, it would have to determine whether default had occurred, both being investigations for which banks are ill-equipped. Whereas, under the independent guarantee, the bank's liability is to be determined solely by reference to the terms of its undertaking to pay and the decision to issue the undertaking depend on the usual investigation of the account party's creditworthiness, without factual investigation into the underlying transaction.[46]

2.4. **Conventional Guarantee vis-à-vis first Demand Guarantee**

The independent guarantee and suretyship share a significant characteristic in that they both provide security to the beneficiary in respect of non-performance by the account party in the underlying transaction.

The difference is that the payment obligation of the guarantor under FDG is by definition independent of that of the account party/ principal debtor, whereas the payment obligation of the surety is co-extensive.[47] In accordance with the principle of co-extensiveness, the surety is entitled to invoke the defenses which the principal debtor might have against the beneficiary and the latter must fully prove his claim as measured by the underlying transaction in case of a dispute.[48] Pursuant to the principle of independence, the guarantor cannot invoke defenses derived from the underlying transaction and his payment obligation is solely defined by the terms of the guarantee.[49] The beneficiary's entitlement to payment under an independent guarantee is defined solely by the terms and conditions as specified in the guarantee.[50]

Traditional means of security, such as the accessory guarantee or suretyship, are cumbersome and disadvantageous to the creditor since the accessory guarantor can invoke every defense which the principal debtor could raise. This often forces the creditor to initiate legal proceedings, which entail further inconvenience and risk. Banks are not very keen to act as accessory guarantors as it is difficult for them to determine in which situations they should proceed to payment and because they may become involved in disputes between the parties to

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[46] Roeland (n 3) 6

[47] Similarly, the Ethiopian contract law reserved the right of benefit of discussion. See article 1934-1937 and Tilahun Teshome, *Basic Principles of Ethiopian Contract Law*, (Addis Ababa University Book center) 2007 262-264

[48] Ibid 261-262 and article 1934 of the civil code

[49] Roeland (n 3) 70

[50] Ibid 13

the underlying relationship. In order to avoid these drawbacks, the independent guarantee was invented, to be issued by reliable and financially sound institutions such as banks.[51]

FDG shares many of the characteristics of documentary credits or commercial letters of credit, notably the rule of independence, the principle that payment is to be made if and only if the conditions of payment as stated in the guarantee, which is ordinarily a documentary nature, have been fulfilled, and the rule of strict compliance. Accordingly, if the terms and conditions of the guarantee are met the bank must pay and it cannot invoke defenses derived from the underlying contract. As ordinarily is the case under suretyship.[52]

The fact that the modern day FDG is a relatively new phenomenon also implies that patterns in respect of notions such as, the construction of the contract, set-off, assignment, conservatory attachment (freezing orders) and the principle of good faith, as they have evolved in other contexts, cannot be transposed mechanically to the independent guarantee.[53]

There are various other contrasting points as well. Among others, primary vs. secondary, unconditional vs. conditional, automatic vs. non-automatic and abstract vs. casual are some.

2.5. **The Notion of Independence of First Demand Guarantee**

An essential feature of FDGs is their independence (or autonomy) from the principal contract. Although the purpose of a guarantee is to indemnify the creditor/ beneficiary for losses resulting from the principal debtor's default in the underlying relationship, the beneficiary's right to claim payment under the guarantee is to be determined solely by the terms and conditions as specified in the guarantee, and the bank cannot invoke defences derived from the principal contract.

The question whether or not the principal debtor has failed to comply with his obligations and whether or not the creditor/ beneficiary is entitled to payment as measured by the underlying relationship is not a relevant issue between the bank and beneficiary. Accordingly, once the terms and conditions of the guarantee are met, the beneficiary/ creditor is entitled to claim payment and he need not show default in any other way than that prescribed by the terms of the guarantee.[54]

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[51] Ibid 2
[52] Ibid 2-3
[53] Cf Dolan, *Banking and Finance* 244
[54] Roeland (n 3) 11

Therefore, terms and conditions of the guarantee document are important, consequently, the terms of the instrument shall be constructed carefully

The bank does not, therefore, become involved in the rights and obligations as they exist on the basis of the underlying relationship and it need not concern itself with any disputes between account party and beneficiary.[55]

The term independence is also used in another context, denoting the independence between the contract of guarantee and the mandate relationship between the bank and principal debtor/ account party, which involves the latter's instruction to the bank to issue the guarantee for his account. Accordingly, the bank cannot invoke defenses which it might have against the principal debtor/ account party.

2.6. Triangular Nature of the Relationship

The nature of FDG requires existence of at least three separate contracts, between the debtor/ account party and creditor/ beneficiary on the one hand which is called the underlying contract and later a contract between the debtor under the underlying contract and the guarantor bank called the mandate contract, often this involves assessment of credit worthiness of the debtor and/ or collateralization of some real property. Thirdly, there is a guarantee contract to be issued for the exclusive benefit of the creditor. Below each form of contract is regarded very briefly.

2.6.1. **The Underlying Contract**

The underlying contract refers to the tender conditions or other relationship between the applicant and the beneficiary on which the guarantee is based.[56] The independent guarantee, as a contract between bank and beneficiary, is a product of the underlying relationship. When parties to the underlying relationship agree to the effect a guarantee will be furnished, they agree to a certain allocation of risks with respect to the realization of claims concerning breach of contract.[57] Parties are expected to include in their agreement to 'pay first and argue later', i.e. payment by way of compensation is to be effected once the agreed conditions of the guarantee have been complied with.

[55] Ibid 12
[56] URDG 758 art 2
[57] Ibid 71

2.6.2. **Mandate Contract**

The relationship between the bank and beneficiary is not affected by the mandate relationship between the bank and the account party. It is independent of the mandate relationship.[58] The bank's obligation and the right to reimbursement are not affected by the rights and obligations, or defenses against compensation as measured by and originating from the underlying contract.

2.6.3. **Guarantee Contract**

The payment obligations of the bank and the beneficiaries' right to payment are to be determined by reference to the terms and conditions as stated in the guarantee and not by reference to the underlying relationship. For the bank, independence signifies that its role is confined to checking compliance with the terms and conditions of the guarantee only which are framed in a documentary fashion.[59]

After payment is made, if the account party is of the opinion that he has correctly performed the contract, he might attempt to recover the amount paid under the guarantee from the beneficiary i.e. 'pay first argue later'.

First demand guarantee is a one-way abstract transaction, in which the emitting bank cannot reject the execution by referring to the non – execution of obligations by the other parties to the transaction.[60] The issuers' independent commitment is sui generis.[61] That is a primary obligation and the cornerstone of the commercial vitality of this instrument of payment.[62]

2.7. **First Demand Guarantees and Roles of Banks**

Undeniably, the sections above indicate some important roles of banks towards the enforcement of FDGs. However, though banks are not the only eligible institutions to issue FDGs,[63] as they are the most dependable one's parties often prefer banks and issuance of such out of banks is an exception, in view of that issuance and examination will be discussed below.

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[58] Ibid 110 & 195

[59] ibid

[60] Serguei A. Koudriachov, '*The Application of Letter of Credit From Payment in International Business Transaction'* 47 (2001) <https://litigation-essentials.lexinexis.com> accessed June 28 2016

[61] Roberto Luis Frias, 'The Autonomy Principle of Letter of Credit'49 <www.Juridicas.unam.mx> accessed May 14 2016

[62] Ibid 50

[63] Under the existing regulatory regime, National Bank of Ethiopia directive no SIB/24/2004, *Prohibition of Issuance of Certain Types of Bonds by Insurance Companies,* banned Insurance companies from issuing FDG.

2.7.1. **Issuance**

By agreeing to issue a guarantee, the bank assumes an obligation of its own to the beneficiary, but for the risk and account of the principal debtor. Should the bank be obligated to effect payment, it is entitled to immediate recourse against the principal debtor. The bank thus accepts a credit risk, which is ordinarily limited by requiring security for reimbursement, and it does not act as an insurer.[64]

In respect of a guarantee, the true parties are the parties to the underlying relationship. The bank is merely an intermediary mandate charged with the implementation of one of the modalities of the principal contract[65]

For the bank, it is of vital importance that the provisions of the guarantee have been drafted in such a way that the bank will be able to determine easily and readily when it is supposed and when it is not supposed to effect payment to the beneficiary.[66]

2.7.2. **Examination on Payment**

As far as banks are concerned, the principle of independence carries a significant advantage. When the guarantee is triggered by a call from the beneficiary, the bank's role is mainly confined to verifying whether the terms and conditions of the guarantee have been complied with. This fact is facilitated by the fact that the conditions of payment are usually framed in a documentary fashion. The bank does not, therefore, become involved in the rights and obligations as they exist on the basis of the underlying relationship and it need not concern itself with any disputes between the account party and beneficiary.[67]

The bank is merely supposed to compare the documents. It does not have to immerse itself in an appraisal of the precise rights and liabilities of the account party and beneficiary on the basis of the principal contract. This would be an onerous and precarious operation for which a bank is neither equipped nor paid.[68]

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[64] Roeland (n 3) 13
[65] Ibid 74
[66] Ibid 87
[67] Ibid 12
[68] Ibid 85

Chapter Three

3.1. Selected International Rules and Practices Governing First Demand Guarantees

Of all the international rules relating to FDG, three have been selected for analysis under this chapter. These rules are selected due to their global recognition. Of the three rules the first two, URDG and ISP are crafted by the ICC, it is a private international organization and association of national chambers of commerce. ICC is established with the view to strengthening commercial ties among nations.[69] Its rules, though international are not binding. The diversity between the civil and common law legal systems obliged the ICC to issue two different rules, URDG for the civil law and ISP for the common-law countries. The third rule is UNICITRAL convention. However, the convention is ratified by only 8 countries[70] among 193 member states of the United Nations. A selected review of relevant subjects is made in comparing these rules. Owing to the fact that six basic comparison points are identified.

I. Application of the Rules

URDG: Due to the non-binding nature of these rules, the only possible scenario to apply the URDG is then based on the consent of parties.[71] URDG is applicable to any demand guarantee that expressly indicates it is subject to them.[72] Furthermore, modification and exclusion of part of the provisions of the rule is indicated.[73] This reserved a room for flexibility. In addition to this, the UDRG recognized the possibility to issue an electronic guarantee.[74]

ISP: In a similar fashion to the URDG the ISP's applicability is grounded on the consent of parties to the underlying or guarantee contract. It stipulated that, *guarantees may be made subject to these rules by express reference to them.*[75] Modification and exclusion of the rule is also recognized.[76] The terminology used to express guarantee under this rule is different, i.e.

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[69]<http://www.iccwbo.org/about-icc/organization>accessed June 12 2016

[70]<http://www.uncitral.org/uncitral/en/uncitral_texts/payments/1995Convention_guarantees_status.html>these countries are, Belarus, Ecuador, El Salvador, Gabon, Kuwait, Liberia, Panama and Tunisia. Though, the USA signed the convention in 1997 not yet ratified it.

[71]*Uniform Rules for Demand Guarantees* (URDG 758) 2010 ICC publication, article 1

[72] ibid

[73] ibid

[74] See article 3(c) and 2 of the URDG 758 the definitions given to the terms "authenticated", "document" and "signed" are indicative of the likelihood to use electronic guarantee. Since the rule is revised in 2010 this latest development is incorporated and it may enable the rule to be electronic technology friendly.

[75] *International Standby Practices* (ISP 98) article 1 (1.01) (b)

[76] Ibid sub article (c)

"standby", an irrevocable, independent, documentary, and binding undertaking[77]. However, in its effect, it is similar to the definition given under the URDG to the demand guarantee. These rules supplement the applicable law to the extent not prohibited by that law.[78]

UNICITRAL: Among the three rules UNICITRAL has certain unique features with regard to the application. To begin with, its resemblance with the above rules it is applicable to an international undertaking[79] the convention defined FDG, as an independent commitment known in international practice, i.e. independent guarantee or a standby letter of credit.[80] This definition is a midway to both the civil and common law legal systems terminologies and definitions.

To enumerate some of its distinctive features, first of all unlike the URDG and the ISP, UNICITRAL convention is applicable to international guarantees only.[81] The Second distinctive feature is the application of the convention requires a connecting factor or fulfillment of tests. These are among others; either place of business of the guarantor shall be in a contracting state[82] or if the place of business of the guarantor does not fall under the jurisdiction of signatory state the other conceivable connecting factor for the applicability of the convention is when the rules of private international law lead to the application of the law of contracting state.[83] Thirdly, once member states to the United Nations are signatory the rules of the convention are automatically applicable if one of the above-stated tests are satisfied. Accordingly, unlike the URDG and the ISP, it is not based on the consent of parties to the underlying contract. Parties shall expressly exclude the application of the rule if they found it detrimental.

II. Interpretation Guidelines and Principles

URDG: Unlike the ISP and UNICITRAL, UDRDG stipulates some important guidelines, whereas, the other rules are inclusive of principles for interpretation. Article 2 of the rule is comprehensive of long list of definitions; this is worthwhile in terms of understanding the terms of the rule. What is more, there are various interpretation guidelines, as an instance, branches

[77] Ibid article 1(1.06)
[78] Ibid article1.02 (a)
[79] *UNICITRAL Convention on Independent Guarantees and Stand-By Letters of Credit* (UNICITRAL) article 1
[80] Ibid article 2
[81] Ibid
[82] Ibid article 1(a)
[83] Ibid article 1 (b)

of a guarantor in different countries are considered to be separate entities,[84] despite the fact that the legal personality is assumed by a single entity.

ISP: Concerning interpretation, the basics are the rule shall be interpreted as mercantile usage;[85] it reflects consistent and uniform business practices that are regularly followed in a particular trade. Trade usage has always played an important role in international sales as is evidenced by the Lex-Mercatoria.[86] To achieve this end integrity, practice, terminology, consistency and uniformity in interpretation are considered as pillars of the interpretation of this rule.

UNICITRAL: UNICITRAL as a convention and enforceable international law among the signatory states is founded on three core principles in its interpretation.[87] I.e. in a way international character is well-thought-out, uniformity is endorsed and the observance of good faith.

In the same way, United Nations Commission on International Trade Law (UNICITRAL), the core legal body of the United Nations system in the field of international trade law is established with the view to modernizing and harmonizing rules on international business.[88] This body was established before the convention was promulgated. As a result, the interpretation principles of this convention are transposed from this essential goal of the UN's specialized commission.

III. Issuance, Form, and Nature of the Guarantees

As regards issuance, all the three rules adopted a similar approach. A guarantee is issued when it leaves the control of the guarantor/issuer.[89]Accordingly, the beneficiary may undertake the transaction is guaranteed from the time when the guarantee enables subsequent claims to be made.

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[84] URDG 758 article 3

[85] ISP 98 article 1.03 see also 2.02

[86]Juana Goetzee, '*The role and Function of Trade Usage in Modern International Sales Law*', (10 July 2015)<http://ulr.oxfordjournals.org>accessed May 7 2016

[87] UNICITRAL article 5

[88]<http://www.uncitral.org>accessed May 9 2016

[89] See article 4 of the URDG 758, article 7 of the UNICITRAL and article 2.03 of the ISP 98, a divergence could be observed in this regard from the ISP, since an exception is provided "unless it clearly specifies that is not then "issued" or "enforceable""

In its form, the undertaking is anticipated to be in a written form. This is prescribed in the various provisions of the three rules.[90]Alike to the international rules, the Ethiopian Civil Code stipulated similar form requirement.[91] Finally, its nature shall be a documentary one.[92]

IV. Independence of Guarantees

The general notion of independence is discussed under chapter 2 (2.5) this subsection will be a reemphasis from its legal aspect perspective.

URDG: The URDG emphasizes the existence of a triangular contractual relationship and independence of each other. *A guarantee is by its nature independent of the underlying relationship and the application, and the guarantor is in no way concerned with or bound by such relationship.*[93] In its effect, this provision of the URDG excludes the other contracts from the triangle and confines itself on the guarantee contract merely. Moreover, reference for the purpose of identifying in no way changes independence of the undertaking. Thirdly the rules lay down the very narrow possibility of set-off; *the undertaking of a guarantor to pay under the guarantee is not subject to claims or defenses arising from any relationship other than a relationship between the guarantor and the beneficiary.*[94]

ISP: Under the ISP nevertheless independence is not dealt in as much as it is emphasized under URDG, recognition to the concept is made in the general provision. *An issuer's obligations toward the beneficiary are not affected by the issuer's rights and obligations toward the applicant.*[95]

UNICITRAL: FDG is acknowledged to be independent under the UNICTRAL as-well[96]. However, in addressing what independence connotes, unlike the former two, it is stated in the affirmative. Consequently, it is independent if it is not dependent upon existence or validity of any underlying relation or it is subject to any term or condition not appearing in the undertaking.[97]

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[90] See for instance the URDG articles 1(c), 2, 4, 19, the ISP articles 1.01 (c) 2.01, 2.03 and UNICITRAL articles 2, 7(2) the cumulative reading of these enumerated provisions are indicative of the form requirement.
[91] See article 1725 (a) of the Civil Code
[92] See articles 6 and 7 of the URDG, articles 2.01 and 4.08 of the ISP and articles 4 and 13 of the UNICITRAL
[93] URDG758 article 5
[94] ibid
[95] ISP article 1.07 see also art 1.08 it is explicitly stated Performance, breach, accuracy, genuineness, action or omission and observance of law are not in any way parts of the guarantor's obligation.
[96] UNICITRAL article 2
[97] Ibid article 3

V. Rules of Examination on Payment

URDG: In the midst of the basic function of a guarantor (often a bank) under FDG, examination is the basic one accordingly the URDG paid due attention and apportioned two detailed provisions. The principle is *the guarantor shall determine, on the basis of presentation alone, whether it appears on its face to be a complying presentation.*[98] Moreover, the subsequent sub-provisions provided a long list of rules of examination of relevant documents. This sub-provision accentuated the documentary nature of FDG.

ISP: On the subject of examination the ISP is much more meticulous. Unsurprisingly, the basic principle is, the demand shall be found to be in compliance with the terms and conditions of the guarantee.[99] In a similar fashion to the URDG documentary nature of the examination is implicated. Regarding the required degree of examination, reference is made to the guarantee, *an issuer or nominated person is required to examine documents for inconsistency to the extent provided in the standby.*[100]

UNICITRAL: In setting the principle of examination the UNICITRAL cross-referred to the standard of conduct and liability of the guarantor, i.e. *the guarantor shall act in good faith and exercise reasonable care*[101]. Contrasting to the above-discussed rules, the UNICITRAL failed to set an objective rule of examination. Instead, it stipulated that *in determining whether documents are in facial conformity with the terms and conditions of the undertaking, and are consistent with one another, the guarantor shall have due regard to the applicable international standard of independent guarantee*.[102] [103]

VI. The Fraud Exception

The URDG is not inclusive of a separate provision as regards fraud. However, the cumulative reading of some of its provisions stands for providing solutions. Article 27 of the URDG freed the guarantor for various fraudulent and document related activities of the beneficiary. In addition, the reference made to the governing law is the other alternative to combat the effects of fraud.[104]A similar approach is adopted by the ISP.

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[98]URDG article 19(a)
[99]ISP 98 article 4 (4.01(a))
[100] Ibid 4(4.03)
[101] UNICITRAL article 14(1)
[102]Ibid article 16
[103] See also chapter 2(2.7) (2.7.2) The notion of examination is look at under
[104]URDG article 34

The UNICITRAL convention[105] gives an appropriate significance to the classical and always controversial exception of fraud. Indeed, the article specifically defines the circumstances in which payment can be withheld and thus establishes a high degree of certainty in respect of the fraud exception.[106] The three substantive grounds to invoke the fraud rule are when:

(a) Any document is not genuine or has been falsified;

(b) No payment is due on the basis asserted in the demand and the supporting documents; or

(c) Judging by the type and purpose of the undertaking, the demand has no conceivable basis.

3.2. International Payment Schemes on First Demand Guarantees

Apart from the specifically agreed upon terms and conditions, the rights and obligations of parties and more explicitly the conditions of payment under a contract of suretyship are fixed by the co-extensiveness principle.[107] By virtue of this principle the underlying relationship is transposed, as it were, to the relationship between surety and creditor, and the content and extent of the surety's liability, both as a matter of substance and as a matter of evidence, is determined by the principal debtors liability towards the creditor rendering to the underlying relationship. This is the characteristic pattern of the suretyship as fixed by law. It is only when parties want to depart from this pattern and when they wish to fix the surety's liability in another manner that they need to insert specific clauses in order to modify the co-extensiveness principle.[108]

On the other hand, FDG is founded on the legal concept, namely an independent guarantee[109] whereby the beneficiary is entitled to payment without any proof of default or the amount of loss. There are various payment arrangements under the independent guarantee.

3.2.1. Types of Payment Arrangement

The types or conditions of payment are among other features of the guarantee form the principal feature of this guarantee type. It determines the actual benefits of the beneficiary creditor and the risk exposure due to the guarantee against the debtor.

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[105] UNICITRAL article 19

[106] Grace Longwa Kayembe, '*The Fraud Exception in Bank Guarantee'* [2008] Senior Thesis University of Cape-town 40

[107] See article 1935 of the civil code

[108] Roeland Bertrams, *Bank Guarantees in International Trade, The Law and Practice of Independent (First Demand) Guarantees and Standby Letters of Credit in Civil law and Common Law Jurisdictions* (third revised edition 2004 ICC publishing S.A Paris – New York, KLUER LAW INTERNATIONAL) 47

[109] See chapter 2(2.5)

3.2.1.1. Payment on First Demand

Of all the payment mechanisms, payment on the creditor's first demand is the prevailing type of payment mechanism.[110] If the guarantee provides for this mechanism the beneficiary is entitled to payment without any condition other than submitting the request for payment.[111] The beneficiary needs not to substantiate his claim for payment, in a way either to identify the debtor's default or his entailment of damage under the secured contract.[112] In the meantime, the unlimited autonomy of the creditor enables him to call the guarantee for its full amount, though the damage the creditor in reality faced is lesser. Nonetheless, this payment arrangement is subject to the exception of the debtor's right to claim later the excess amount based on the renowned principle of "pay first argue latter".

As a result of this paramount nature of the payment mechanism, the guarantor is duty bound to effect payment of the guarantee amount to the extent required by the creditor within the limits of the agreed sum, without requiring any additional proof of default or application of procedure for prior examination.

On the other hand, there is a possibility to attach some additional conditions while issuing the guarantee. The most employed alternatives to the simple demand are requiring a statement of default and/or prior default notice to the debtor. In this case, the guarantor owes a duty to the debtor to verify that the correct statement as prescribed in the guarantee has been presented and it must refuse payment if the statement has not been tendered.[113]

3.2.1.2. Payment upon Submission of Third Party Documents

This payment mechanism is much more stringent against the creditor's interest compared to the first demand scheme. The conceivable alternates to use third party documents for payment of the guarantee are either the beneficiary itself may bring certain third party documents which assure default of the debtor. Or while the creditor's first demand is conveyed to the attention

[110]Interview with *Mandefro Mihrete*, A/Manager Legal Services, Commercial Bank of Ethiopia (Addis Ababa, Ethiopia 7 April 2016)
[111] Roeland (n 41) 48
[112] See for instance rule 4.16 and 4.17 of the ISP 98
[113]Roeland (n 41)288

of the guarantor, the debtor may be required to tender certain documents which affirm the performance of the underlying contract.[114]

Here the issue to be raised might be can this guarantee payable upon submission of third party documents safely categorized under first demand guarantee? The quick answer for this is any other first demand guarantee's call likewise requires for at least demand of the creditor or default statement. Consequently, if one of this is not fulfilled payment may not be effected under the FDG. By the same token, once the third-party document is fulfilled the guarantee may get immediate effect equally to other first demand guarantee.

Under this mechanism, the beneficiary is compelled to furnish some evidence of non-performance on the part of the debtor.

3.2.1.3. Payment Upon Submission of Arbitral Award or Court Decisions

Unlike the above mentioned two mechanisms, an arbitration or court decision is a prerequisite under this for payment. The litigation shall be decided on the merits of the cases of parties. The decision shall base on a full- fledged review of facts and the law vis-à-vis the guaranteed contract. The guarantor or often the bank is not supposed to be a party. As a first demand guarantee, this type of guarantee may merely ascertain the full execution of the award or judgment.

There are certain criteria which the arbitral or judicial decision must always meet and which must be ascertained by the bank. It must be apparent from the decision that it relates to the dispute between the account party and beneficiary concerning the underlying contract covered by the guarantee. It must also be apparent that judgment is given against the account party for a specified amount.[115]

As far as the possibilities of challenging the judicial decision or arbitral award are concerned, the decision or award needs not satisfy requirements which have not been stipulated in the guarantee. Payment cannot be claimed should, in the meantime, the decision has been reversed on the merits of the case.[116]

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[114] Ibid 54
[115] CF. Eisemann, *Revenue Arbitrage* [1972] 395
[116] Roeland (n 41)295

3.2.2. Demand for Payment and Other Conditions

Demand is defined under various international rules relevant to FDG. Among others, it is understood as either a request to honor or a document that makes such request.[117] Thus in order to give effect for the guarantee, a complying demand shall be made. The debtor is entitled to ask the bank for a copy of the beneficiary's request for payment.[118] This right is decisive for the debtor to institute an after-payment claim, either from the beneficiary creditor or if the demand lacks conformity from the bank. Not only conformity rather the identity of the person who called the guarantee is also decisive. Therefore, only the designated beneficiary shall call the guarantee. Lastly, the other concern worth mentioning is, as there is a possibility of having various contracts among parties, the call shall relate to the secured contract.

The nature of FDGs is flexible enough for the inclusion of various particular conditions for each guarantee. For instance, attaching a condition precedent, limitation clauses, and reduction clauses are some. Accordingly, the guarantor bank shall extend its examination towards such documentary conditions as well whenever they are adopted.

[117] ISP article 1.09 (a) similarly the URDG defined it as "signed document by the beneficiary demanding payment under a guarantee"
[118] Roeland (n 41) 279

Chapter Four

The Status of First Demand (Independent) Guarantees under the Ethiopian law

Guarantee is an important tool to enhance the assurance of contracting parties with regards to enforcement of contracts,[119] due to the fact that contract law needs to regulate such problem in general. Likewise, the Ethiopian contract law consists various provisions of related nature. In principle, the notion of guarantee is all about assuring the performance of a contract and comparable approach is adopted.[120] What is more, the law expressly indicates the leeway to use securities as a guarantee. i.e. contract of pledge[121] and mortgage.[122] In view of that, it is not arguable the concept of guarantee is incorporated to the Civil Code. To this extent, the concept of guarantee was developed by the time the code was promulgated.

The Civil Code uses the terms surety and guarantee interchangeably from article 1920 onwards. As the Civil Code is the governing law to guarantees, it is important to examine the acceptability of FDGs under the contract law. In this regard, practicing lawyers have a difference of opinions. Some raise the accessory nature of guarantee as a basic reason and disregard the recognition of independent guarantee contract. A writer emphasized this concept; by saying *the existence of two separate but related contracts should be noted in suretyship.*[123] Others raise various provisions of the law and criticize the first opinion as a reductionist. Below an attempt has been made to incorporate both views.

4.1. The Place of First Demand Guarantee under the Surety Provisions

In assessing the compatibility of the Civil Code provisions towards FDG, it will be helpful if terms are taken from a practical guarantee as an illustration.

… *We, the bank, as instructed by the contractor to* agree unconditionally the payment to the employers *on their first written demand without whatsoever right of objection on our part and without their first claim to the contractor….*[124]

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[119] The notion of guarantee in general is discussed under chapter 2(2.1)

[120] See article 1920 of the civil code, *whosoever guarantees an obligation shall undertake towards the creditor to discharge the obligation, should the debtor fail to discharge it*

[121] *Civil Code of the Empire of Ethiopia* Proclamation No. 165 of [1960] article 2825 and the subsequent provisions

[122] Ibid article 3041 and the subsequent provisions

[123] Mulugeta M. Ayalew, *Commentary of Laws of Contracts*, (Wolters Kluwer Law and Business August 2010) 212

[124] Guarantee issued by Addis International Bank Hawassa Branch, in favor of Commercial Bank of Ethiopia, dated July 20/2012

The terms of the above-stated guarantee are indicative of a scenario whereby the beneficiary creditor receives immediate payment of the guarantee forthwith when he notified the bank that the principal debtor in whose favor the guarantee issued defaults. There is no need to establish one's demand and payment shall be effected regardless of the objection of the debtor. The nature of the instrument suggests that the guarantee is independent of the primary obligation of the debtor under the underlying contract.

On the contrary, the Civil Code emphasizes the accessory nature of the guarantee. *Whosoever guarantees an obligation shall undertake towards the creditor to discharge the obligation, should the debtor fail to discharge it.*[125] As a result, the creditor needs to prove the default of the debtor and there is inseparability between the main and the guarantee contracts. Nonetheless, this is not the only provision indicative of inseparability of the two contracts, article 1923 (1) and 1926 (1) could also be considered as supportive provisions in this regard. Therefore, this poses a critical question against the acceptability of FDGs under the Civil Code,[126] in the same way, the writing from Bankers Association[127] disregarded the applicability of the civil code and emphasized on the divergent nature of the instrument.

4.2. Provisions of the Civil Code Pertaining to First Demand Guarantee

4.2.1. Provisions against the FDG

Here, one may enumerate various provisions of the code under this subsection. In the direction of examining contradictory articles, the first provision could be article 1924 of the Civil Code. The provision explicitly endorsed that, *a guarantee may not exceed the amount owed by the debtor,* ***nor be contracted on more burdensome terms*****.** Nonetheless, beneath FDG the guarantor (banks under the Ethiopian reality) is anticipated to contract on more burdensome terms. The extract taken from a guarantee of Addis International Bank S.C above proves a more burdensome obligation of the guarantor bank. This is the case while the debtor may raise various defenses including but not limited to, the creditor's default; the guarantor is contractually precluded from doing so. This reality may lead us to conclude that FDG is more burdensome to the bank.

[125] Civil Code (n 3) article 1920
[126] See chapter two with regards the basic nature of FDGs
[127] This piece of writing is annexed to this paper.

In addition, sub-article (2) of article 1924 emphasizes that; it may be contracted in respect of part only of the debt and subject to less burdensome terms. This sub-provision denotes the accessory nature of guarantees. As the obligation of a guarantor is set to remain less burdensome in its extent and the guarantee shall cover only the amount of the debtor's obligation or part of it. This is unlike the principle of independence under FDG.

Article 1924 lastly governs the effect of guarantee contracts concluded contrary to the above two sub-provisions, *a guarantee which exceeds the amount of the debt, or which has been contracted on more burdensome terms, is not void but merely reducible to the amount of the primary debt.* The sub-provision addresses the extent of the amount a guaranter may guarantee. Moreover, it is indicative of other obligations too, beyond and above the amount of the guarantee.

Secondly, article 1942 is inclusive of rules nonconforming with the attributes of FDG. Sub-article (1) of the provision is definite that the guarantor has *the right and the duty to set up against the creditor all the defenses available to the principal debtor*. These defenses could be; the benefit of discussion, the benefit of division and summons to proceed.[128] Hence this is the rule the guarantor is obliged to raise the above defenses and other defenses too if any. Sub-article (2) of the provision implies the consequences of not raising all the defenses. *The guarantor who fails to set up such defenses is debarred from his remedy in so far as they would have relieved him of payment.* As a result, the guarantor's right of subrogation to the rights of the creditor[129] will either get refused altogether or limited to the extent he paid defendable claims of damage of the creditor. The law is watchful to make the guarantor reasonably careful enough upon payment.

On the other hand, the guarantor under FDG is expected to forgo one's right to raise defenses contractually while the right of subrogation is reserved to it, be it through the instrumentality of collaterals or through the mandate contract between the guarantor bank and the debtor. This poses another question against the legality of FDG since it disregards the mandatory obligation of the guarantor under the law from the very beginning.[130]

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[128] Tilahun Teshome, *Basic Principles of Ethiopian Contract Law*, (Addis Ababa University Book center) 2007 262-265

[129] See article 1944 (1) of the Civil Code (n 3)

[130] The Civil Code (n 3) while it stipulated mandatory provision under 1942 it also incorporated a permissive provision under article 1926(2); "The guarantor may setup against the creditor all the defences available to the debtor"

Thirdly, the other major right recognized under the Civil Code for a guarantor is the benefit of discussion. Based on this right *the guarantor may require the creditor to discuss the principal debtor as soon as he first proceeds*.[131] Thus, if the guarantor is successful in indicating the debtor's asset,[132] ever since his obligation is assumed to be accessory by the law, he will be free of paying the debtor's debt. However, under the FDG as the name suggests the guarantor is expected to pay the claim of the creditor forthwith. Whether the debtor's asset is liquid or not could not be an issue. The liquidity position of the debtor may help the guarantor only in the enforcement of its subrogation right. Therefore, one may safely assume that FDG precludes a guarantor from using this right.

4.2.2. Provisions in favor of the FDG

Equally to the existence of likely provisions against the acceptability of FDG under the Ethiopian legal system, there are some provisions which formed a room for its acceptability. Among these provisions article 1942 (1) of the civil code is one. Even if this provision is analyzed above as a provision contrary to the acceptability of FDG under the contract law, it has particular importance in the justification of same. *The guarantor has the right and the duty to set up against the creditor all the defenses available to the principal debtor*. Nonetheless, the same provision puts an exception to the exclusion of raising such defenses by the guarantor, ever since it acknowledged the possibility to exclude same *by the nature of the guarantee.* Thus the nature of FDG is perceivable to be exclusionary of all the possible defenses of the guarantor. As a result, the guarantor could be legitimately relieved from raising any defenses against the creditor based on this provision. In effect it is possible; to argue not raising any defense upon payment may not limit the subrogation rights of the guarantor.[133]

In addition, one of the legislative defenses against the acceptability of an FDG is because it impairs the right of benefit of discussion. Whereas if the guarantor agreed to be a joint guarantor, co-debtor or equivalent;[134] may not raise the defense of the benefit of discussion. No matter sufficient liquid asset is available in the hands of the debtor. Correspondingly based on the sample taken above from the terms of Addis International Bank S.C's advance payment

[131] Ibid article 1935 of the
[132] Ibid article 1936
[133] This is particularly a concern for the guarantor since sub article (2) of 1942 may limit the rights of subrogation for failing to raise defences.
[134] Civil Code (n 3) article 1933(1)

first demand guarantee, the bank implicates the debt as its own. Therefore, raising the elimination of benefit of discussion under FDG as against the contract law may not hold.

Thirdly, one of the issues raised against the acceptability of FDG is for the reason that it's more burdensome to the guarantor. Here at this point the issue worth to be addressed is, does the law completely debar the possibility of contracting a more burdensome guarantee or hitherto there is an exception for this concern. In favor of the counter argument articles, 1923(2) and 1926 (3) may be raised. The provisions are indicative of a scenario wherein a guarantor may guarantee voidable contract while the principal debtor is not duty bound to perform the underlying contract guaranteed. This is particularly a case for the existence of more burdensome terms under a guarantee contract. And this scenario may be used to argue in favor of FDG's legality constructed on analogy.

Accordingly, the law takes into consideration the informed consent of the circumstances, under the two sub-provisions above to assume a more burdensome obligation. If that is the case it is rare to undertake a setting wherein a guarantor bank may not know the effects of terms under an FDG. As FDGs are allowed to be issued only through banks, i.e. financial institutions assumed to be well staffed or assisted by expert consultants of a different profession, including legal professionals. As a result, the prohibition against more burdensome guarantee might be an overrated one.

It is visible that both positions for and against the acceptability of FDG raised robust arguments. Nevertheless, it is agreed that principles are the very basis while we analyze and interpret laws. Consistently, it is difficult to justify FDG under the civil code. As it explicitly emphasized in principle guarantees are accessory. The researcher attempted to find the minutes of the then parliament in this regard. To strengthen one of the two positions above, nonetheless, there is no available archive at the National Archives and Libraries Agency. Besides to this the idea of using FDG was realized in the mid-1960s while the Civil Code was promulgated in 1960.[135] This excludes the possibility of raising the intention of the legislator as a foundation for the recognition of this particular guarantee type.

[135] See chapter 2 (2.3)

4.3. Other Legislative Basis

As FDG is being issued by banks[136] it is impossible to disregard the banking laws in assessing the governing law for this subject matter. Book IV of the Commercial Code, in general, comprises various provisions to govern issues associated with banking operation in general. Whereas, there is no provision that directly or indirectly fits into the problem at hand. However, it has been noted under chapter two and chapter three of this research, FDG shares some features of a letter of credit. And the commercial code explicitly governs subject matters of a letter of credit.[137] In view of that, some suggest that inclusion of governing provisions to FDG under the upcoming commercial code, as the commercial code is under the process of amendment by the office of attorney general.[138]

Contemporarily, there are other important legal instruments for the banking industry. These are the National Bank of Ethiopia Establishment (as amended) Proclamation No. 591/2008, Banking Business Proclamation No. 592/2008 and various directives issued based on these proclamations. The instruments are important in searching provisions for the justification of FDG.

While both proclamations define what banking, business is they included various enumerations. It is important to employ the relevant ones to the topic. The first of the list indicate, *receiving funds from the public through means that the National Bank has declared to be an authorized manner of receiving funds.*[139] This is conventionally known to be part of the banking business. Consistent with the Commercial Code[140] the proclamations render the bank ownership of the funds deposited. *Under the account and risk of the person undertaking banking business to use the funds, in whole or in part, for loans, investments and for purposes that the National Bank has declared to be appropriate.*[141]

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[136] See Amendment of Prohibition of Issuance of Certain Types of Bonds by Insurance Companies SIB/24/2004

[137] The commercial code is criticized by the banking lawyers to be inadequate; in governing matters associated with letter of credit. The basis of their criticism is basically founded on comparison with UCP 600 and rules of other legal systems. Interview with Sosina Alemayehu, Senior Attorney, Commercial Bank of Ethiopia (Addis Ababa, Ethiopia 9th August 2016)

[138] Interviews with *Takele Arega*, Director Legal and Loan Recovery, Awash International Bank S.C. 6th October 2016), *Dula Merera*, Chief Legal and Loan Recovery Councilor, (Abyssinia Bank S.C. 6th October 2016) and *Abdulkerim Dawed*, Team Leader Loan Recovery, Commercial Bank of Ethiopia 11th October 2016, (all the three interviews are made in Addis Ababa, Ethiopia)

[139] *The National Bank of Ethiopia Establishment (as Amended) Proclamation* No [591/2008] and *Banking Business Proclamation* [No. 592/2008] articles 2(2)(a) of both proclamations.

[140] Commercial Code of the Empire of Ethiopia, Proclamation no [166 OF 1960] article 896

[141] *Banking Business Proclamation* (n 20) article 2 (2)(b)

The very question to be raised here is then, is FDG a loan or among those purposes declared appropriate by the regulator to use the funds deposited? These issues will be addressed in this chapter below under 4.6 (4.6.1).

The third pertinent banking business under the proclamations is, *any other activity recognized as customary banking business, which a bank engaging in the activities described is authorized to undertake by the National Bank.* Thus, custom has its own importance to consider an activity as a banking business under the law. Likewise, both in Ethiopia and under the other jurisdictions FDG is recognized as a banking business. This may lead to the conclusion FDG is acceptable under the Ethiopian law.

Another important base is the National Bank's authority to license, regulate and supervise banks.[142] Ever since the National Bank is empowered to issue banking license, it has the supremacy to examine the memorandum and articles of associations of banks while establishment and later during subsequent amendments. Once these company constitutions are accepted by the regulatory the contents thereof shall be considered to be legal.[143] Consistently various banks claimed the explicit or implicit inclusion of FDG under their constitution as a sufficient legal base. Moreover, the banks are required producing their draft internal procedures upon issuance of their license.[144] This among others includes credit procedure of the banks. Therefore, the banks argue ones this procedure is accepted by the National Bank it may serve as a base for the issuance of FDG. The other likely legal argument in favor of this guarantee type is the definition given to loan or advance[145].

The last from the banking law to be raised in defense of FDG may perhaps be SIB 24 Prohibition of Issuance of Certain Types of Bonds by insurance companies. The directive may play various important roles. Its nomenclature is indicative of the rationale behind its issuance. Insurance companies are prohibited from issuing FDG for at least five reasons. The trend of not backing the guarantees with collateral upon issuance, the inapplicability of the foreclosure proclamation for the benefit of insurers, unavailability of credit information of the debtors to be guaranteed, exclusion of the reinsurance scheme and the act of issuing guarantees is

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[142] *The National Bank of Ethiopia Establishment Proclamation* (n 20) articles 7 and 14

[143] Interview with Takele Arega (n 19)

[144] Interview with Banking Supervision Directorate Senior Supervisor, *preferred to be anonymous*, The National Bank of Ethiopia, (Addis Ababa, Ethiopia 9th October 2016)

[145] See part 4.6 below.

considered by the National Bank as the borrowing of money.[146] In this regard, lawyers from the insurance industry criticize the justifications as fragile.[147]

An additional contribution of this short directive worth mentioning is the importance of its definitions. Yet there is no accompanying legislative base for the interpretation of FDG in Ethiopia. Whereas, the directive defined what is called "Financial Guarantee Bond" and "Unconditional Bond". Under the two definitions, the concept of payment of guarantee to a beneficiary upon demand and without attaching any pre-conditions for payment is introduced.[148] These two concepts are the cornerstones of FDG. What is more, while the directive expressly prohibits insurance companies from issuing what it calls "Financial" and "Unconditional" bonds it is silent concerning banks. This could be considered as implied recognition[149] in conjunction with the other provisions of the proclamations discussed hereinabove.

Furthermore, the customs proclamation no 859/2014 is another legal instrument worth consideration. Article 118 (1) of the proclamation includes the term "bank guarantee". Though bank guarantee is not defined under the proclamation customarily this refers to FDG. However, the nomenclature is not the only reason to assume FDG is incorporated. What is more sub-article 3 of article 119 of the same proclamation indicate that the obligation of the guarantor is independent and the guarantor is excluded from raising any defenses.

Lastly, the courts in general and the Federal Supreme Court Cassation Bench in particular use two other proclamations in passing judgment over matters associated with FDG. The first of which is the stamp duty proclamation no 110/1998 and Federal Government of Ethiopia Financial Administration Proclamation no 648/2009. Both proclamations are used in dealing with the form requirements of FDG. Since simplified expressions are used for guarantees i.e. "any instrument" and "something given" respectively. These proclamations stipulated less stringent requirements than provided under article 1727 of the Civil Code. Meanwhile, the objective for which the proclamations issued was distinct with governing or regulating FDG owing to this reason there is no much specificity to the subject matter.

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[146] SIB 24/2004 (n17) Preamble and interview with, *kibre Moges*, Director Legal Services and *Ephrem Baraki*, Senior Legal Advisor, National Bank of Ethiopia, (Addis Ababa, Ethiopia September 15th 2016)

[147] Interview with *Alemayehu Birbirsa*, Head Legal Services, Abay Insurance S.C and *Ambatchew Tarkegne*, A/Head Legal Services, Lion Insurance Company, former Judge at the Federal First Instance Court (Addis Ababa, Ethiopia 14th September 2016)

[148] See article 1 of the directive SIB 24/2004 (n 17).

[149] Interview with Ephrem Baraki (n 27)

4.4. The Ethiopian Law of Contract and its Approach towards Private Contract

Globally there are two polarized views regarding the extent of legislative and/or judiciary limits against private contracts. These views are articulated by various scholars under different names. Among others, libertarian Vs conservative, contextual Vs formal and minimalist Vs maximalists are some. Despite the difference in nomenclature, while the first groups call for least intervention to the extent possible the second competing view demand existence of public interest limitations.

4.4.1. The Minimalist Approach

Contemporarily legislators and courts tend to reduce the number of rules controlling contract power. They see the role of contract law in enforcing the agreement of the parties. Similarly, some scholars[150] suggest that the law should enforce any agreement which was 'freely made' between parties provided it has no adverse effect on others. These 'libertarians' see the individual as the best judge of his or her own interest and consider that what was freely agreed is by definition, fair.[151] For the adherents of this approach, the law should give effect to the expectations, practices, and desires of the business community. Because, the proponents of this approach see the role of contract law as an instrumentalist, i.e. to aid and enhance the market. A contextualist law of contract would give primacy to standards such as good faith and unconscionability and look to business norms and practices to interpret contracts and to fill gaps where necessary. Such a law would be dynamic because it would be continually refined to give effect to changing business norms, expectations and behavior.[152] This view refers to new forms of contracts and their increasing complexity as demanding recognition through the development of doctrine and interpretation to reflect these new contractual realities.[153]

4.4.2. The Maximalist Approach (Public Interest Concern)

Others take a less extreme position. They agree that individuals should be free to pursue their own self-interest but they recognize that in some cases 'the market' may not operate efficiently. They would say contract law, whether we like it or not, do affect the distribution of wealth in

[150] Friedrich Haye, klysander Spooner, John Locke and others.
[151] John Gava, *The Law of Contract* (11th ed. 2005) 46
[152] ibid
[153] ibid

society and that this should be recognized.[154] This view argues that since business uses law selectively it would be Counterproductive if the law were anything other than predictable.[155] Various practitioners agreed that the Ethiopian contract law explicitly concurs with the second approach. As there are various limitations to contracting freedom of parties. Lawyers' interviewed in this regard identified various provisions as an illustration. I.e. 1710(2), 1711 and 1731(2) are some among others.

4.4.3. Freedom of contract vis-à-vis FDG

Under the Ethiopian contract law, there are various indices for the freedom of contracting parties. Among others, the law stipulates that a contract shall depend on the consent of the parties who define the object of their undertakings.[156] Further, on the subject of determination of the object, the law recognized freedom of parties, *subject to such restrictions and prohibitions as are provided by law*.[157] Regarding the type of contract, parties may enter into, all the three forms, i.e. obligations to give, to do or not to do are incorporated.[158]

However, the freedom of contract under the law is not absolute; the phraseology subject to such restrictions and prohibitions as are provided by law is one among other limitations. The limitation is there, to attain social justice, peace, and tranquility.[159] There are various particular reasons for the limitation of freedom of contract among others; the protection of the disadvantaged from the wealthy was emphasized by the socialist political economy theory. Contemporarily, the existence of various anticompetitive agreements i.e. horizontal, vertical and concerted agreements come to be among the reasons for the limitation.[160] The third major limitation is defensible on the basis of public order or morality.[161]

Krzechzunowich analyzed the concept of freedom of contract and its limitation. He stipulated that as to private law, such of its rules as are mandatory are also called rules of 'public order'. They must be obeyed because the public interest is involved. Consequently, most legal rules of contract are permissive, they only supplement the contract. Parties thus lay down their own

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[154] Paul Richards, *Law of Contract* (7th ed.2006) 278
[155] ibid
[156] Civil Code (n 3) 1679 & 1711
[157] Ibid 1711
[158] Ibid 1712
[159] Paul (n 35) 281
[160] See for *Trade competition and Consumer's protection proclamation* no. 813/2013 Article7
[161] Civil Code (n 3) 1716

contractual "lex specialis" which may derogate from the permissive legal provisions.[162] This writer complied with the need to adopt maximal freedom of contract. On the other side, the drafter of the Civil Code indicated the place of freedom of contract in his own words. The parties determine freely the object of the contract, the obligations that each of them is to undertake. The principle of contractual freedom is fundamental to a society and an economy that want to leave the considerable scope of the private initiative.[163] The only exception is when the law provides otherwise.[164]

In a similar fashion to the above-mentioned arguments, various practitioners interviewed for this study purpose raised the principle of freedom of contract, as a legal base for the acceptability of FDG. These experts mention various provisions discussed above as a foundation for their argument. However, there are some particular arguments in this regard. The first of the arguments is that, the inexistence of specific law. Since there is no specific law to govern FDG the contracting power of parties shall be taken as a base. The argument further raised the generality of laws and the need to fill such gaps using various mechanisms. The second justification for the recognition of freedom of contract for the legality of FDG bases itself on the inexistence of harm to the public at large. For this argument, the limitation of freedom of contract shall be placed only when and where the contracting parties endangered third parties and public interest. The third justification raises the existing practice. Currently, FDG in Ethiopia is governed by the terms and conditions included under the guaranty instruments.

The other argument raised is freedom of parties shall not be limited to the extent of creating terms and conditions, rather it shall be understood that it allows integrating various internationally relevant rules as a gap filling. Among others, the URDG 758 is the notable one.[165]

Consequently, it is easily conceivable that the notion of freedom of contract is accepted as a legal base by most practitioners involved. Their justifications are based on pragmatic

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[162] George Krzechunowich, *Formation and Effects of Contracts in Ethiopian Law* (Faculty of Law Addis Ababa University 1983) 8

[163] René David, *Commentary on Contracts in Ethiopia* (the Faculty of Law, Haileselassie I University Addis Ababa 1973) 27

[164] Ibid 92

[165] Interview with *Ephrem Baraki* (n 27)

reasoning. They are concerned with giving effect to the guarantee instrument at large. In effect, they disregard some of the legal issues raised above.

4.5. The Role of Courts in the Enforcement of First Demand (Independent) Guarantees

The nature of FDG is limitative to the role of courts. Since FDGs often, forgo all the possible defenses. As pointed under (4.2) above banks and debtors guaranteed by FDG are left with post-payment rights only. This is consistent with the principle of 'pay first argue latter'. This idea is emphasized by an expert writer in the area. *It must also be borne in mind that fraud is, in practice, virtually the only defense available when one seeks to escape payment under a demand guarantee.*[166] Accordingly, it is important to examine this sporadic exception of fraud.

4.5.1. The Fraud Exception

Findings from country experiences designated three basic questions of fraud. I.e. does fraud require evidence of deceitful or malicious conduct on the part of the beneficiary? Is fraud to be determined by having regard to the underlying relationship or is it restricted to fraudulent acts within the confines of the contract of guarantee (fraud in the documents)? What is the standard of proof of fraud?[167] In order to properly address these issues, it is important to examine some available country experiences.

4.5.1.1. The Netherlands

The case law indicates that demand for payment should not be honored if the call is 'evidently arbitrary or deceitful'. A strong standard of proof with the prerequisite for the existence of a substantive element of fraud is implicated.[168] If it is established beyond reasonable doubt that the beneficiary has no claim against the account party/ principal debtor, bad faith the guarantor is not expected to pay. However, the evidence of fraud must be clear. It must be evident that no reasonable creditor in the particular circumstances of the case would have called the guarantee.[169]

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[166] Roeland Bertrams, *Bank Guarantees in International Trade, The Law and Practice of Independent (First Demand) Guarantees and Standby Letters of Credit in Civil law and Common Law Jurisdictions* (third revised edition 2004 ICC publishing S.A Paris – New York, KLUER LAW INTERNATIONAL) 335

[167] ibid

[168] Ibid 338

[169] Ibid

4.5.1.2. Germany

Fraud constitutes a defense for the bank and justifies a refusal to pay. Fraud shall be examined by reference to the underlying contract. Arbitrariness, abuse, and bad-faith are the most popular. The other typical reason is when the creditor is without grounds or justification or in violation of the principal contract or more specifically if the beneficiary has no right to payment whatsoever. The proof of the facts which constitute fraud must be clear, evident, beyond doubt and immediately available.[170]

Consequently, the experience of the two countries suggests that fraud needs to be examined through cross reference to the underlying contract. And there is a strong specific requirement with regards proof.

4.5.2. The Procedure for Courts Intervention and the Standard of Proof

In this regard, the examination is made on the procedural law and the practice in the federal high court. The Civil Procedure Code is inclusive of various interlocutory remedies. Specifically, the provision regarding temporary injunction may be used in justifying the intervention of courts. However, the relevance of the provisions to entertain stop payment orders against FDGs needs a further consideration. *In any suit for restraining the defendant from committing a breach of contract prejudicial to the plaintiff, the plaintiff may apply to the court for a temporary injunction to restrain the defendant from committing a breach of contract or act complained of or any breach of contract*.[171]

Under this provision, the term 'prejudicial to the plaintiff' is the important one and it binds courts for proper scrutiny. The renowned jurist of Ethiopian Civil Procedure analyzed the surrounding issues. *Where the plaintiff has brought suit to restrain the defendant from committing a breach of contract or other act prejudicial to him a temporary injunction to restrain the breach or the commission of the act may be granted*.[172] In determining whether a temporary injunction against the breach of a contract should be granted, the court must consider whether assuming the plaintiff's claim will be approved he would be entitled to an injunction as a final relief in the suit.[173] He further argued that the issue shall be seen in a manner consistent with article 2121, i.e. when the would-be damage cannot be redressed by an award

[170] Ibid 341
[171] The *Civil Procedure Code* [Decree no 52 of 1965] article 155
[172] Robert A Sedler, *The Ethiopian Civil Procedure*, (Faculty of Law Haileselassie I University in Association with Oxford University Press) 366-367
[173] Ibid

of damages. Therefore, an injunction against contracts would be given when specific/forced performance and injunction as part of the final remedy is claimed.[174]

Based on the provisions of the Civil Procedure Code stated above the questions to be answered are then; can one say it is impossible to redress the damages due to the payment of FDG? Since there is no possibility to require forced performance basing FDG, is it possible to claim injunction as a final remedy? Before answering these two questions it is important to study the current day practice. Three federal high court judges and associate judges[175] were interviewed as regards issues of the injunction. All interviewees pointed that a case by case assessment is important to conclude whether an injunction shall be handed as against FDG or not. Nevertheless, in general, for these judges, there is no plausible legal justification to require stringent precondition before ordering an injunction. So long as an application corroborated with an affidavit in a manner consistent using articles 154 and/or 155 of the Civil Procedure code is brought it will be an adequate ground.

Nonetheless, there is a slight divergence of opinion as regards to the proof required before passing the injunction order. Ato Sintayehu and Ato Feqadu believe that it is sufficient if the court finds availability of an ordinary proof. Consistent to the degree required for other civil matters. As stated under article 154 of the civil procedure code. Ato Ashenafi by the other side raised the non-inclusion of the degree of evidence under the civil procedure code. However, he indicated that it is understood among practitioners and judges the degree of proof for civil matters is a preponderance of evidence. Since there is no prohibition in the procedural law judges may demand different levels of proofs depending on the nature of the case and the interests at stake. Accordingly, he raised the nature of FDG and as the defenses are avoided earlier by the guarantee contract while the injunction is requested, raising a defense as a base, the court may require a stronger degree of evidence. What he called it 'the balance of convenience proof'.

The latter view seems to be consistent with the various literature on the field and the country experiences indicated above. The basic reason for an injunction is to avoid unjust enrichment and fraud. According to these judges often FDG is being used for construction contracts. Its purpose is to back advance payments and performance of the contractor to the satisfaction of the employer. They argue in defense of their stand due to the existence of abuse against this

[174] Ibid 368

[175] Interviews with *Sintayehu Zeleke,* Judge Federal High Court, *Feqadu Damena*, Associate Judge Federal High Court and *Ashenafi Lemecha*, Associate Judge Federal High Court, (Addis Ababa, Ethiopia 22 September 2016)

guarantee. By either calling the guarantee after the advance payment is returned through payment certificates or the contract is performed.

The possibility to redress the damages due to the payment of FDG is disregarded by the interviewed judges and they argue otherwise. According to them, it is possible to terminate the likely irreparable damage to the plaintiff or debtor in the underlying contract. Moreover, they say if the injunction is denied the cause of action may get gone altogether. In the examination of the possibility to claim injunction as a final remedy, they all agreed it is possible when there is no cause to use the guarantee. For these judges, this implies the existence of fraud on the side of the beneficiary.

An expert in the area wrote a newspaper article.[176] He noted that FDG is preferred to enhance trust, to avoid cash deposit and to compensate the creditor forthwith whenever default is presumed by the creditor. This approach according to him is created to sidestep the difficulty of proofing default. Nonetheless, he admitted the fact that this guarantee type is easily prone to abuse by the creditor. No matter there is a high degree of risk for abuses he argued the nature of the contract is the very base. Consequently, he concluded that it is against freedom of contract to pass injunction for whatever reason. Additionally, he analyzed the relevant provisions of the Civil Procedure Code, article 154 and 155. Based on his analysis it is against the code to pass injunction as per article 154. However, he accepted the possibility to pass injunction order against contracts under article 155. Nevertheless, the law puts four preconditions rendering to this newspaper article. I.e. the existence of irreparable damage, the result of the injunction shall be anticipated to be of greater interest than the inconvenience to be created due to it. The need to maintain status-quo and impossibility to enforce the would be judgment without injunction if the court passed judgment in favor of the plaintiff.

To end with the writer concluded injunction order against FDG may not fulfill the above prerequisites. And courts shall refrain from banning the payment of FDG. This position appears to be an extreme one. It disregarded the stoppage of fraud. Although fraud existed during the call of the guarantee, rendering to him the remedy shall be post payment damage.

To close this part, the judiciary should pay proper attention. If injunction order is passed every now and then the guarantee documents may get futile. And the injunction orders may equate FDG to the ordinary guarantee/ surety. This is detrimental in line with the anticipated result of FDGs. If courts keep rendering injunction without proper examination to the cause and strength

[176] Birhanu Beyene Birhanu, '*The Guarantee Being Out of Use Due to Injunction of Courts'*, (translation mine) Reporter Newspaper (Amharic Version) (Addis Ababa, 15 November 2015 V.21 number 1622, column Behege Amlak 46-47

of proof adduced, contracting parties may eliminate FDG as an alternative and prefer to use cash (Cashiers Payment Order (CPO)) as a guarantee. Thus fraud shall be considered as the only exception to pass injunction order with the stringent proof requirement.

4.6. First demand guarantees and the practice of Commercial Banks

It has been noted earlier that FDG in Ethiopia is legally allowed to be issued by banks. The customary practice attached a name to this guarantee type as 'bank guarantee'. Consequently, it is generally understood that the guarantees are first demand and independent of the underlying relationship. Nevertheless, there are various cross-cutting issues to be examined under this subtopic.

4.6.1. First demand guarantees as a credit product or a service?

In this regard, there are differing views. In order to identify the practice three of the commercial banks, heads of legal departments, lawyers from the National Bank and employees from the Banking Supervision Directorate are interviewed. The result indicates that some considered it as a loan product. Others as a service and the third category of view is the possibility of categorizing both as a credit or service based on various reasons.

At this juncture, all the three views raised their own justification. The proponents of categorizing FDG as a credit product validate their stand. First of all, they raise the possibility of categorizing loans as an off-balance sheet and on-balance sheet.[177] Off-balance sheet activities are activities which are not formally reflected on financial statements. These are largely loan commitments and contingencies that generate income and/or hedge risks.[178] Accordingly, they categorize FDG as an off-balance sheet loan. Moreover, the credit procedure of banks is raised as the second justification. Since most commercial banks credit procedure is governing FDG[179]. As an instance the Commercial Bank of Ethiopia's credit process procedure volume I part 3.6 articulate the preconditions, types, and authorized personnel issuing such guarantees. Thirdly, the arrangement of collaterals in issuing FDG by the banks is considered. The second view by the other side raises the fact that banks are practically collecting service charges, not interests as a profit due to the issuance of a guarantee, thus it is difficult to consider FDG as a credit product.[180] The second justification is the practice of issuing guarantees against cash. Under this arrangement, the commercial banks issue the guarantee after receiving the full

[177] Interview with Anonymous (n 25)
[178] <www.actuaries.org> *accessed 19 August 2016*
[179] Interview with Takele Arega (n 19)
[180] Interview with Dula merera (n19)

amount of the guarantee.[181] Proponents of the third view by the other side accept the justifications stated above and preferred to examine each guarantee on a case by case basis so that one can easily categorize whether a particular guarantee is a loan or a service product.

4.6.2. First Demand Guarantees and the Power of Foreclosure

It has been indicated above there is a practice of calling collaterals while issuing FDG. Based on such practice, we need to question whether the law squarely fits into the understanding of the interviewed practitioners, or it is against the law to consider FDG as a loan. There is a thoughtful issue around this and the power of foreclosure of banks requires scrutiny too.

Accordingly, we need to address the following questions; what do we mean by a loan under the law? Does FDG fall in the definition of loan? What are the preconditions of using foreclosure power? Are all these preconditions full-fillable in the case of FDG? If the foreclosure proclamation is not accommodative of the bank's subrogation right, what alternative is there?

In addressing the first question examining the definition of a loan under the Civil Code will be helpful. *The loan of money is a contract whereby a party, the lender, undertakes to deliver to the other party, the borrower, a certain quantity of money and to transfer to him the ownership thereof on the condition that the borrower will return to him as much of the same kind.*[182] Similarly, a writer emphasized the applicability of such definition. Without consideration to the type of loan, the relationship between the bank and the borrower is a debtor-creditor relationship. Their relationship shall be governed under Title XII, contracts in general and provisions from 2471-2489, loan of money and other fungibles[183].

The definition above comprises at least three basic elements for the conclusion of loan contract. I.e. delivery of a certain quantity of money, transfer of the ownership of the money delivered and the existence of a return condition. If these are prerequisites for the conclusion of a loan contract under the law, the subsequent question is does FDG fall under such definition? All the selected banks for this study indicated that there is no delivery of money while the guarantees are issued. If there is no delivered money, there is no need to examine the other subsequent elements of the definition given by the law to the notion of loan.

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[181] Interview with Ephrem baraki (n 27) see also Commercial Bank of Ethiopia Credit Procedure article 3 (3.6.1)
[182] Civil Code (n 3) article 2471
[183] Tilahun Teshome, '*Some Points on Laws Relating to Banks and their operations'* [2006] Ethiopian Bar Review V1 no 1 118

As indicated above there is a practice of using collaterals while FDG is issued. Thus if and when the bank's customers failed to repay what the bank paid to the beneficiary, can the banks use the power of sale foreclosure?

In examining the issues of foreclosure, a closer analysis to the proclamation, the property Mortgaged or Pledged with Banks Proclamation No. 97/1998 is a necessity. In view of that, it is worth considering first of all what the very purpose of the proclamation was. The second paragraph of the preamble stated that *banking business thriving on interest payments on loans it provides from public money received by way of saving deposits or acquired from other sources*. Accordingly, the legislator was cautious to protect the banking business in relation to its loan collection activity in general. By doing so it protects depositors and creditors interest in particular. Likewise, the third paragraph of the preamble includes a reassurance i.e. *enabling banks to collect their debts from debtors efficiently.*

Another inferring justification that the proclamation's applicability is limited to loan is the explanatory note attached by the drafter's committee to the then members of the house. The first sentence explicitly mentions of loan reimbursement. The third proof for the intention of the legislator is the motion submitted by the standing committees[184] it repeatedly mentions of loan settlement. By the same token, the minute of the parliament noted down while the foreclosure proclamations were enacted could be taken as the other validating ground.[185] What is more article three of the proclamation indicates the essential elements. A loan is implied and non-payment of claim within the time stipulated is another precondition. If there is no loan legally speaking and there is no pre-determined time framework of repayment it is not within the ambit of the proclamation to use the power of sale foreclosure.

However, one other possible line of argument is, based on the definitions from the banking business proclamation and the directive, Credit exposure to single and related counterparties SBB 53/2012. The proclamation's article 2(13) defined the term loan. Conversely, there is a clear deviation between the English and Amharic versions of the proclamation.[186] The expression promise to pay money from the Amharic version may be used to justify FDG as a

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[184] Federal Democratic republic of Ethiopia, *House of peoples' representatives, motion number* 2/1990 E.C; initiated by the Economic and Legal affairs standing committees of the house, unpublished

[185] Federal democratic Republic of Ethiopia, *House of Peoples Representatives 3rd year of the term 18th meeting minute,* Yekatit 12/1990 E.C

[186] While the Amharic version includes the phrase, "ገንዘብ ለመስጠት ቃል ከመግባት የሚመነጭ" (promise to pay money) there is no equivalent for such expression under the English version. As stated by the Federal Negarit Gazette Establishment proclamation no 3/1995 article 2(4) in case of discrepancy between the two versions the Amharic shall prevail. This problem is caused largely due to the fact that the proclamation was drafted by foreign experts employed by the World Bank.

loan. If this definition is considered as a legal justification banks may safely use the power of sale foreclosure. But the question is, is the Amharic version of the definition clear enough? If not shall we remain to apply the definition of the Civil Code? If courts used the Civil Code in defining loan can they adequately address the issue realistically?

Besides the directive's article 3(3) defined the term loan. In doing so it directly copied the proclamations definition with qualifying words. The major addition of the directive's definition is it adds standby letters of credit (the equivalent term for FDG under the common law legal system), guarantees (this mainly refers to FDG) or surieties issued on behalf of a borrower. Despite these additions are included under the directive there are series of questions. Among others may a directive issued based on a proclamation redefine a term already defined under the source proclamation? If so can it be in a different manner that may cause amendment?

At this point, the other issue worth to be addressed is if the power of sale foreclosure is not readily available for collaterals used in the process of issuing FDG, what other alternative is there? The issue of extending foreclosure power and its legality was raised to four different banking lawyers.[187] With exception of one[188] the others argued it should be applied to collaterals registered in case of issuing guarantees too whereas their justification differs. Ato Takele basis his argument on the mandate contract between the debtor who requested the guarantee and the guarantor bank. He strongly raised that article 3 of the proclamation merely recognized an agreement of parties to use the power of sale foreclosure. In the same way, parties may agree to use it in the process of issuing FDG. Ato Dula, on the other hand, bases his argument on the nature of the law, i.e. civil and the possibility to use analogy in civil law matters and the effect of using foreclosure sale. He believed that this will in no way become detrimental to the interests of their customers, profoundly due to the fact that the civil procedure code's applicability in the process. He further raises the question of the effect of using judicial foreclosure? According to him, there is no practical difference. He preferred the power of sale foreclosure since its effectiveness is proved.

[187] Interviews with *Takele Arega, Dula Merera, Ephrem Baraki* and Abdulkerim Dawid (n 19 and 27)

[188] Interview with Abdulkerim Dawid ibid

4.7. Case Analysis

Case One

Federal Supreme Court Cassation decision numbers 36935, 40186, 40187 and 43467[189]

Under these cases, the applicant guaranteed a loan repayment. For the benefit of creditor banks in favor of its third-party clients; in all the cases, it refused payment of the guarantee while the debtors defaulted. Accordingly, the banks brought a court case and it is forced to litigate against various commercial banks. All the cases were tried before the Federal High Court, Supreme Court and Cassation Bench of the Supreme Court. The banks were beneficiaries of the guarantees upon their first written demand. The causes for the applicant's rejection were;

I. Based on its object of trade as stated under article 105 (g) of the Commercial Code and its memorandum of association, the applicant raised issuing FDG is an outlawed obligation.
II. The applicant raised the form requirement as stated under article 1727 of the Civil Code.
III. Further, the general manager's power to issue such guarantee is appealed as defective.
IV. As the applicant is insurance company it raised the period of limitation applicable to insurance contracts based on article 674 of the commercial code.
V. Lastly, based on Directive of the National Bank the applicant argued that insurance companies may not issue such guarantees. Founded on all the above arguments the applicant argued the guarantees are void abinitio.

The court in its findings rejected all the claims of the applicant establishing for various reasons.

A. The argument based on the trade objective of the applicant is found to be improper. Since issuing such guarantees were legally possible for insurance companies by the time the applicant provided the FDGs in question for the benefit of the commercial banks. Save the prohibition of the National Bank. Since the regulator prohibited

[189] *Africa Insurance S.C Vs Commercial Bank of Ethiopia* [2012] Federal Supreme Court Cassation Decision V.13 383-391, *Africa Insurance S.C Vs Dashen Bank S.C* [2012] Federal Supreme Court Cassation Decision V13 402-416, *Africa Insurance S.C Vs Abyssinia Bank S.C* [2012] (Unpublished*) Federal Supreme Court Cassation Decision and Africa Insurance S.C Vs Awash International Bank S.C*. [2012] (Unpublished) Federal Supreme Court Cassation Decision respectively. These cases are treated as a single case for various reasons. Under all the cases the applicant is Africa Insurance S.C., the issues framed by the court are nearly identical, comparable applications and defences are raised.

insurance companies' latter on. The applicant pointed out that it is established to provide only short and long term insurance services. And the business of insurance is defined under article 654 of the Commercial code. Consequently, issuing financial guarantee is out of the scope of the insurance business, the applicant argued. The court in entertaining this issue relied on article 26 of the Commercial Code. Since companies are not allowed to engage in activities out of the scope of their registered trade objective. Similarly putting articles 100, 105(g) and 106 of the Commercial Code together, it is found to be a valid argument to raise the commercial objective of a company as a cause for invalidating a contract. However, in reaching its conclusion contrary to the argument of the applicant, the cassation bench relied on the time of issuance of directives of the National Bank.

B. With regard to the power of the applicants General Manager similarly the court decided against the applicant. The court raised the question what are the powers of a general manager under normal circumstances? It answered such question via reference to the Commercial Code. Subsequently, it examined whether the applicant limited the power of its general manager properly, through registration made on the commercial registration. The finding of the court to the second question was negative. Thus it raised article 35 of the code and concluded that a general manager may sign any document containing an obligation.

C. Dealing with the form requirement of the contract law, the court concludes that such requirement is amended by article 2 (2) of the stamp duty proclamation no 110/1998 and financial administration proclamation no 648/2009. In reaching this conclusion the antecedent question raised was whether the instrument is a guarantee or insurance policy? As a result, it is considered as a guarantee based on the definition given to financial guarantee in the directives. Whereas the court concluded, nonetheless it is a guarantee it has unique features. Thus, the form requirement is believed to be left out by the above two proclamations.

D. As to the period of limitation according to the Cassation Division, ever since the guarantee fulfills the requirements of 1920 and subsequent provisions the applicable rule is found to be 1845 of the Civil Code. The court considered such obligation as a joint guarantee as stated under article 1933 of the Civil Code. Correspondingly, the right of the guarantor to raise defenses related to the period of limitation is noted. However, the basis to reach the conclusion is article 1929, meanwhile, it indicates that similar period of limitation is in place against the debtor and the guarantor.

It is easily visible that the cassation bench is cautious to give pragmatic solutions to the issues it framed. This approach has its own merits and demerits. The strong side of the decision from this perspective is the position of the court on the period of limitation issue and the recognition of FDGs in general. Surprisingly the cassation assimilated the nature of FDG to joint guarantee, while there is a clear difference between a joint guarantee and FDG.[190] The other peculiar nature of the cassation bench's decisions is regarding the form requirement. It neglected the form requirement altogether without adequate legal basis. In general, these decisions of the cassation bench are groundbreaking vis-à-vis FDG. As the cassation decisions are binding on the interpretation of laws.

Case Two

Federal Supreme Court Cassation decision number 47004[191]

Under this court case, the applicant provided a performance bond for the benefit of the respondent. While payment was claimed the insurance, company rejected it. The basis for the rejection was a period of limitation as stated under article 674 of the Commercial Code. Whereas the respondent argued all over the levels of litigation, the performance guarantee is subject to the Civil Code.

The court in its judgment assessed the nature of insurance contract. Accordingly, it put emphasis on the absence of insurable interest. Based on its conclusion it emphasized the accessory nature of guarantee and decided that performance guarantee is subject to the provisions of the Civil Code. Thus the period of limitation applicable is found to be 10 years unlike the argument of the applicant.

From FDG's perspective, this decision has detrimental effects. Among others, the court emphasized accessory nature of guarantees. Moreover, the court excluded performance guarantees from the category of 'unconditional' guarantees. Lastly, it expressly indicated gratuitous nature of guarantees. Consequently, the questions to be paused are; does this mean it is impossible under the current Ethiopian contract law to conclude independent guarantee contracts? What is the real difference between the definitions given to 'Financial Guarantee Bond' and 'Unconditional Bond'? And lastly is the practice of Ethiopian banks i.e. issuing

[190] Under joint guarantee despite the guarantor assumed a co-debtor position he is not deprived of raising the defences available to the debtor. Whereas such right is not available under FDG, see part 4 (4.2) above.
[191] *Ethiopian Insurance Corporation Vs Bale Rural Development organization* [2012] Federal Supreme Court Cassation Decision V.13 392-398

FDG against the law? These issues are addressed under the previous sub sections. Due to that, no attempt is made to address them under this subsection.

Case Three

Federal Supreme Court Cassation decision number 98874[192]

The respondent of this case had a procedure to guarantee exporters loan to be taken from commercial banks. The procedure was dependent upon its directive number 34. I.e. directive on establishment and operation of export credit guarantee scheme. As a result, the respondent guarantees an exporter while it borrowed 15,000,000.00 Birr. The nature of the guarantee was "unconditional" and "irrevocable". In its effect, the guarantor agreed to waive all kinds of defenses whether legal or factual. The borrower defaulted and the applicant claimed payment. Later the National Bank rejected payment of the guarantee.

The respondent in its reasoning justified its decision to reject payment. While it admitted the nature of the guarantee was unconditional and irrevocable. Moreover, it also admitted it waived all defenses during the issuance of the guarantee. Its justification was based on the nature of the guarantee. The applicant bank is the exporter's bank in a documentary credit. Consequently, payments from the opening bank are channeled to the borrower through the applicant itself. Thus the applicant was anticipated to settle the guaranteed debt using such payment. Nonetheless, it used the proceeds of exporter's sales to settle different unrelated debts. This makes the liability of the respondent extincted. The applicant by the other side admitted it used the proceeds to settle other unrelated claims. However, it relied on the argument that there is no clear prohibition to this effect.

The court in its decision analyzed provisions of the above-mentioned Directive and the Civil Code. Its interpretation of article 5 and 11 of the directive and the applicability of the contract provisions leads to the conclusion that the guarantor is free from its obligation. The Cassation Bench considered the nature of the loan in its analysis. Besides, it emphasized freedom of contract as a basis for the disputed obligation. Thirdly as the conditions of repayment were not plain enough, it considered provisions of contract interpretation and custom of the business. Therefore, it accepted the defense of the guarantor.

[192] *Wegagen Bank S.C Vs the National Bank of Ethiopia* [2015] (unpublished) Federal Supreme Court Cassation Decision

This case is decisive to assess at least three important issues surrounding FDG. These are the recognition of the guarantee by courts specifically the Cassation Bench. The legal basis for FDG is said to be *freedom of contract*. Finally, the possibility of raising the fraud exception to deny payment of guarantee though a first demand guarantee is agreed. This judgment is very much helpful in answering alike issues.

Case Four

Federal Supreme Court Cassation decision number 23003, Supreme Court decision number 54843 and High Court decision number 71236

These three decisions are selected in addressing the form issue. The Cassation's decision interpreted article 1725 of the Civil Code. Since the provision is entitled *contracts for a long period of time*, the Court finds it to be relevant only for contracts to be effective for longer than two years. Equally, the Supreme Court adhered to such decision, based on the Federal Courts Proclamation Re-amendment proclamation no 454/2005. Then it reversed the decision of the High Court to invalidate a performance guarantee issued by Abyssinia Bank S.C.

Notwithstanding the provision is entitled contracts for a long period of time, the issue worth addressing is shall we consider only the time factor? The form set by the legislator may serve interests of third parties too. Hence interpreting what long term contract is against the clear meaning of the law. While the law is clear enough to require all guarantee contracts shall be made in a written form. The decision is also against the golden rule of interpretation of laws. However, this form issue is set aside by means of different legal reasoning as stated under case one above.

Case Five

Federal High Court decision number 161705[193]

This file is closed based on the basis of the preliminary objection. The objection used by the court to dismiss the case was related to jurisdiction of the court. In their contract the parties excluded court litigation; instead, they included adjudication and arbitration clauses. However, the case is relevant to examine the practice of courts in passing injunction order against FDG.

[193] *Sirak Seblu General Contractor Vs Commercial Bank of Ethiopia* [2015] (unpublished) Federal High Court

On the order dated Tahsas 3/2007 E.C the court passed injunction order. To suspend the payment of FDG to the defendant from the issuer Addis International bank S.C. the court does not show which procedural base is used in its order. It simply passed such order due to the simple fact that the plaintiff requested an injunction. What is more, the court denied the request of the defendant to set aside its order based on article 158 of the Civil Procedure Code.

The court by accepting the injunction request and passing the order, it altered the first demand nature of the guarantee altogether. And the plaintiff was able to raise its defenses for non-payment. This is clearly against the independent nature of first demand guarantee and may turn it to be an accessory. Furthermore, it is inconsistent with the cassation decisions above, while the interpretation of the law by the cassation bench is binding on lower level courts.

Case Six

Federal High Court decision number 162121[194]

The plaintiffs, in this case, are building contractors. They used the service of the defendant bank to issue a first demand advance payment guarantee. The beneficiary of the guarantee was Oromia Regional State's Health Bureau. The plaintiffs assert that they were successful in bringing injunction before payment from Oromia Regional State Bale Zone High Court. However, according to them, the defendant infringed such order. They brought the case based on their belief that the payment was made after the expiry of the guarantee. Finally, they claimed injunction of the proposed foreclosure by the defendant against the collaterals. The plaintiffs claimed the injunction as a permanent relief.

The respondent by the other side raised a preliminary objection. Ever since the disputed properties are mortgaged for repayment of the bank's claim if and when it paid as per the advance payment guarantee. Thus according to it, the court may not assume jurisdiction, based on the proclamation to provide property mortgaged or pledged with banks no 97/98 article 3.

Finally, the court in its finding concludes that the contract of sale foreclosure is applicable for loans. Loan is defined under article 2471 of the Civil Code. The activity of issuing guarantees under whatever form may not fall in such definition of the law. As a result, it accepted the claim of the plaintiffs and passed an order to entertain the case in its full-scale level.

[194] *Daniel Tesfaye and Rahel Abera Vs Birhan International Bank S.C* [2015] (unpublished) Federal High Court

This case is important in addressing one of the five research questions of this paper, i.e. the applicability of the power of foreclosure of banks. Though, other definitions are given under the banking business proclamation and the directive issued by the National Bank. Yet the civil code's definition is important since there are confusions surrounding the other definitions.

Case Seven

Federal Supreme Court Cassation Decision number 100668, Federal Supreme Court Decision number 95849 and Federal High Court Decision number 96583[195]

The commercial Bank of Ethiopia was responsible for a performance guarantee. Later on, while payment claimed the bank refused to pay. The basis of its refusal was that the guarantee issued in contravention to its internal procedure. The bank argued that this defect renders the guarantee void. The Federal High Court accepted the argument and invalidated the guarantee.

The beneficiary took its appeal to the Federal Supreme Court. It argued that the internal procedure could not be binding on third parties in any way. If there was an infringement of internal procedure as alleged by the respondent its remedy shall be to subrogate and claim the infringer after payment of the performance guarantee.

The Supreme Court while analyzing the fact in issue vis-à-vis the 'relevant' law concluded that the governing provisions are article 1920-1951 of the Civil Code. Moreover, it underlined gratuitous nature of guarantees basing on article 1921 of the Civil Code. In addition, it dismissed the possibility to reject payment of an FDG for the mere fact that the guarantor's employee failed to obey internal procedure during issuance.

The Bank took the case to the Cassation division of the Federal Supreme Court. However, upon conferring its decision the Cassation bench concluded that the Supreme Court has not committed any basic error of law.

These series of decisions signify that the Civil Code provisions are considered to be applicable by all levels of the Federal Courts against FDGs. However, it implies the existence of confusion

[195] *KLR Ethio Water Hole Digging Enterprise Vs Commercial Bank of Ethiopia* [2015] (Unpublished) Federal Supreme Court Cassation Bench, *KLR Ethio Water Hole Digging Enterprise Vs Commercial Bank of Ethiopia* [2013] (Unpublished) Federal Supreme Court and *KLR Ethio Water Hole Digging Enterprise Vs Commercial Bank of Ethiopia* [2012] (Unpublished) Federal High Court. These cases are litigated over a particular performance guarantee by and between identical parties, thus considered here together.

in relation to the nature of FDG. Recognition to FDGs is beheld while gratuitous nature of guarantees is underlined at the same time. As the Banks are delivering the service professionally and for gain, it is hard to imagine a scenario whereby they will provide it gratuitously.

Conclusions and Recommendations

This study considered the notion of guarantee in general and first demand guarantee in particular under the Ethiopian legal system. As FDG is relatively a new phenomenon to the Ethiopian legal system, its peculiar features are stressed. Among others, its independence to the underlying contract, on-demand payment, without the need to establish one's case, and the complete reallocation of risk are examined. What is more, widely known international rules and practices are considered vis-à-vis the research questions. Finally, this paper endeavored to assess the status of FDG under the Ethiopian law and some other surrounding critical legal issues. In this process, the study comes up with the following major conclusions and recommendations.

I. Conclusion

i. The Legality of FDG under Contract Law

- As specified in chapter four of this research, FDG is a professional activity for the commercial banks and the later are doing it for gain. Whereas, the Civil Code acknowledged the gratuitous nature of guarantees. Thus, this is one of the legal reasons for the incompatible nature of FDG under the Ethiopian contract law.
- The contract law explicitly prohibited making a guarantee contract more burdensome to the guarantor than the obligation of the debtor to be guaranteed. Whereas, the nature of FDG requires contracting more burdensome terms. This is an additional implication for the incompatibility.
- Thirdly, the contract law provisions emphasized the accessory nature of guarantee contracts. Accordingly, the guarantee contract shall be dependent on the principal /underlying/ contract. However, the nature of FDG makes the guarantee contract independent of the underlying or principal contract.
- True, some of the provisions of contract law are raised as justifying the legality of FDG under the contract law by various practitioners and members of the judiciary; these arguments are largely dependent on analogy and fragile by their method.
- The other perspective worthy of consideration at this point is freedom of contract. Despite the fact that it is important to any contractual relationship, the law may limit the extent of the freedom. When there is an explicit limitation party to any contract shall abide by the rules of limitation. Therefore, since there are limitations against FDG as stated above it is not plausible to consider freedom of contract as a legal base.
- As a result of the above ins and outs, it is possible to conclude that FDG is not accorded with a space under the Civil Code.

ii. The Legality of FDG under Other Legislative Basis

Since the contract law is found to be unhelpful to govern FDG, the research attempted to look for other likely governing laws. Therefore, the examination is made towards various proclamations and directives governing the banking business in general. Furthermore, the Customs Proclamation is considered. Such an examination suggests that there are provisions which may back the legality of FDG.

- Particularly, banks have reserved the right to use deposits they mobilized, through alternatives that the National Bank declared to be appropriate. It is noted under chapter four of this study that commercial banks are duty bound to request approval for their credit procedures. Meanwhile, all banks included the procedure of issuing FDG under their credit procedure. In effect, once the procedures are approved by the regulator inclusive of the details to issue FDG, this may lead to the conclusion issuing FDG as an activity declared to be appropriate by the National Bank, to use deposits that the banks mobilized.
- The other corroborative base is; the proclamations' recognition to customary banking business activities. It is not arguable that issuing FDG is customarily recognized as a banking activity under the Ethiopian and other jurisdictions, too. Thus, one may safely conclude that this might be a legal basis for its recognition.
- Thirdly, SIB 24 implicitly recognizes the issuance of FDG by commercial banks.

Despite the fact that there may be a contradiction between the aforementioned proclamations and the Civil Code, as the banking proclamations are the later laws there is no doubt that they will prevail. Nevertheless, these scattered provisions are inadequate in governing the relations between parties involved. Consequently, the subject matter is left for the terms and conditions of contracting parties as agreed, by and between them.

iii. The Role of courts

Generally, the role of courts shall be kept minimal, in order to make FDG serve its intended purpose. However, the sample of cases considered for this study suggests otherwise. Courts assume the comparable role. I.e. a role they are playing and expected to play for conventional or ordinary guarantees. Decisions of courts including the Federal Supreme Court Cassation Division are dependent on the provisions of the Civil Code. In effect, it is intermittent to assume a scenario where in the courts kept their role to be minimal, while they apply provisions of an ordinary guarantee.

In a consistent manner to the international practice; fraud shall be considered as the only exception. Courts shall require proof to be adduced, and the proof needs to demonstrate,

any other creditor may not call the guarantee had he been in the position of the creditor. The proof shall be stronger than a preponderance. In this regard 'balance of convenience' or 'a proof beyond reasonable doubt' shall be employed.

In addressing the proper procedure article 155 of the Civil Procedure Code may be used. In doing, so fraud of the creditor shall be proved and injunction shall be claimed by the debtor as a permanent redress. Issues of temporary injunction shall be eliminated altogether and plaintiffs may claim damage later on.

iv. Making Use of Power of Foreclosure Sale

In this respect, the property mortgaged or pledged with banks proclamation is explicit that the power of sale foreclosure is extended only for the purpose of loan repayment due to the fact that defining the term loan was substantial. There are three distinct definitions for the term. These definitions are listed discussed and analyzed under chapter four 4.6(4.6.2). Of all the three definitions, if we use the definition from the Civil Code it is against the proclamation to use the power of sale foreclosure. Nonetheless, the National Bank establishment and the Banking Business proclamations defined it differently and the Amharic version of the proclamations, i.e. the governing one, has room to interpret in a manner to extend this power for post payment of FDGs. However, the expression 'promise to pay' (literal translation of the relevant part of the Amharic definition) is still vague whether it includes an independent guarantee to be issued by commercial banks or not. Despite the vagueness courts of law may use it as a justifying provision. Therefore, since the proclamations are the latter laws than the Civil Code they shall prevail.

The third definition is from a directive, SBB 53/2012. The definition of the directive is explicit enough to include FDGs and any other guarantee to be issued by banks. Nonetheless, this directive is issued based on the Banking Business Proclamation. As a result, to redefine the already defined term under the source legislation is against the principle of hierarchy of laws. This makes the directive null in vindicating the use of the power of sale foreclosure.

II. Recommendations

i. Adequate Legal Framework Shall be put in place

The analysis made under chapter four of this study and the concluding remarks suggest that there is no adequate legal framework to this problem. Although various moderating legal bases are used to argue in the affirmative to the legality and acceptability of FDG, all are based on analogy. True, there is no prohibition to use an analogy for civil matters. However,

with the exception of answering the legality of the guarantee instrument, various other subsequent legal questions may not be answered using analogy in the same direction.

This being the case, the legislator may use various alternatives to back this instrument. The most viable alternative at this point in time is to include some relevant provisions in the upcoming Commercial Code.

ii. Involvement of Courts shall be limited

- To limit the role of courts to the extent desired, the very first apparatus is to create a legal framework as stated above.
- On the other hand, creating a legal framework is a time taking development. Due to the formal law-making process and this may not hold in the short time span. As a result, training members of the judiciary regarding the nature of FDG, in general, is a key. Particularly ever since the widely used governing rule by the commercial banks while issuing FDG is URDG 758;[196] it will be beneficial to extend the judicial training in a manner to be inclusive of this rule.
- The third alternative to limit judicial involvement is to use cassation power of the Federal Supreme Court.[197] *As the interpretation of a law by the Federal Supreme Court rendered by the cassation division with not less than five judges shall be binding on federal as well as regional council at all levels*.[198] This bench may pass groundbreaking decisions in this regard. Unlike the current relevant and existing cassation decisions.[199] In order to use such remedy the banks, as often are parties to cases involving FDG they may use their association as a channel of creating a similar position.

iii. **Power of foreclosure shall be extended**

One of the results indicated under this study is that it is against the essence of the existing law to use the power of foreclosure. Whereas, most of the commercial banks are using such power against collaterals employed during the issuance of FDGs. It is significant to reconcile this gap between the law and the practice. The data collected for this study indicated the issuance of FDG is becoming among the dominant businesses of commercial banks. Thus this makes the

[196] This rule is discussed under chapter three of this study.

[197] Strong power of cassation is recognized under the Constitution of the Federal Democratic Republic of Ethiopia Proclamation No. 1/1995 article 80 (3) i.e. The Federal Supreme Court has a power of cassation over any final court decision containing a basic error of law. Particulars shall be determined by law. By the other side the particulars of this power are enshrined on Federal Courts Proclamation Re-Amendment Proclamation No.454/2005

[198] Ibid article 4

[199] The current Cassation decisions are detrimental towards FDG. See the case analysis under chapter four. Nonetheless the Cassation Bench is authorized to change its stand over matters that it already rendered interpretation of law. See article 4 of Federal Courts Proclamation Re-Amendment Proclamation No.454/2005

issue vital for the health of the banking industry. Moreover, as these guarantees are expected to be paid on demand this may pose a greater risk of liquidity against banks. Thus the banks shall be legally authorized to use the power of sale foreclosure for the collaterals they mortgaged during issuance.

In this regard, there are two alternatives to extend the applicability of power of foreclosure towards FDGs. The first one is to amend Property Mortgaged or Pledged with Banks Proclamation No. 97/1998 and Business Mortgage Proclamation No. 98/1998. The amendment may be made in a manner to include the power of foreclosure sale towards independent guarantees to be issued by banks. The second alternative is to amend either the Civil Code or Banking Business Proclamation No. 592/2008. Since the two laws define what 'loan' is it is conceivable to extend the meaning of loan in the direction of FDGs too by amending one or the other.

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II. Legal Instruments

A. National Instruments

- A proclamation to Amend, the National Bank of Ethiopia Establishment Proclamation No 591/2008 Federal Negarit Gazette 14th yr No 50
- Banking Business Proclamation No. 592/2008 Federal Negarit Gazette 14th yr No 57
- Civil code of the Empire of Ethiopia, Proclamation No 165/1960 Negarit Gazette 19th yr No 2
- Commercial Code of the Empire of Ethiopia, Proclamation No166/1960 Negarit Gazette 19th yr No 3
- Credit Exposure to Single and Related Counterparties SBB No 53/2012 (unpublished)
- Federal Public Procurement Directive, Ministry of Finance and Economic Development (No not available) (unpublished)
- Prohibition of Issuance of Certain Types of Bonds by Insurance Companies, SIB 24/2004 (unpublished)
- Property Mortgaged or Pledged with Banks Proclamation No. 97/1998 Federal Negarit Gazette4th yr No 16

- The Customs Proclamation No 859/2014 Federal Negarit Gazette 20th yr 82
- The Federal Negarit Gazette Establishment Proclamation No 3/1995 Federal Negarit Gazette 1st yr No 3
- The Federeal Government of Ethiopia Financial Administration Proclamation No. 648/2009 Federal Negarit Gazette 15th yr No 56
- The Stamp Duty Proclamation No 110/1998 Federal Negarit Gazette 4th yr no 36
- Trade Competition and Consumer's Protection Proclamation No. 813/2013 Federal Negarit Gazette 19th yr No

B. International Legal Instruments

- UNICITRAL Convention on Independent Guarantees and Stand-By Letters of Credit (UNICITRAL)
- Uniform Demand Guarantees Rules (URDG 758) 2010 ICC publication
- International Standby Practices (ISP 98)

III. Cases[200]

- Africa Insurance S.C Vs Abyssinia Bank S.C [2012] (Unpublished) Federal Supreme Court Cassation Decision Court f.no. 40187
- Africa Insurance S.C Vs Awash International Bank S.C. [2012] (Unpublished) Federal Supreme Court Cassation Decision Court f.no. 43467
- Africa Insurance S.C Vs Commercial Bank of Ethiopia [2012] Federal Supreme Court Cassation Decision V.13 Court f.no. 36935
- Africa Insurance S.C Vs Dashen Bank S.C [2012] Federal Supreme Court Cassation Decision V13, Court f.no. 40186
- Daniel Tesfaye and Rahel Abera Vs Birhan International Bank S.C [2015] (unpublished) Federal High Court, Court f.no. 162121
- Ethio Telecom Vs Abyssinia Bank S.C and Datema Trade and transport [2010] (Unpublished) Federal High Court, Court f.no. 71236

- Unpublished cases are annexed herewith

- Ethio Telecom Vs Abyssinia Bank S.C and Datema Trade and transport [2011] (Unpublished) Federal Supreme Court, Court f.no. 54843
- Ethiopian Insurance Corporation Vs Bale Rural Development organization [2012] Federal Supreme Court Cassation Decision V.13 Court f.no. 47004
- KLR Ethio Water Hole Digging Enterprise Vs Commercial Bank of Ethiopia [2012] (Unpublished) Federal High Court, Court f.no. 100668
- KLR Ethio Water Hole Digging Enterprise Vs Commercial Bank of Ethiopia [2013] (Unpublished) Federal Supreme Court, Court f.no. 95849
- KLR Ethio Water Hole Digging Enterprise Vs Commercial Bank of Ethiopia [2015] (Unpublished) Federal Supreme Court Cassation Bench, Court f.no. 96583
- Sirak Seblu General Contractor Vs Commercial Bank of Ethiopia [2015] (unpublished) Federal High Court, Court f.no.161705
- Wegagen Bank S.C Vs the National Bank of Ethiopia [2015] (unpublished) Federal Supreme Court Cassation Decision, Court f.no. 98874

IV. Others

A. Interviews

- Interview with, Abdulkerim Dawed, Team Leader Loan Recovery, Commercial Bank of Ethiopia
- Interview with, Alemayehu Birbirsa, Head Legal Services, Abay Insurance S.C
- Interview with, Ambatchew Tarekegne, A/Head Legal Services, Lion Insurance Company and former Judge at the Federal First Instance Court.
- Interview with, Ashenafi Lemecha, associate Judge the FDRE High court
- Interview with, Banking Supervision Directorate Senior Supervisor, preferred to be anonymous
- Interview with, Dula Merera, Chief Legal and Loan Recovery Councilor, Abyssinia Bank S.C
- Interview with, Ephrem Baraki, Senior Legal Advisor, National Bank of Ethiopia
- Interview with, Fekadu Damena, associate Judge the FDRE High court
- Interview with, kibre Moges, Director Legal Services National Bank of Ethiopia
- Interview with, Mandefro Mihrete, A/Manager Legal Services

- Interview with, Sintayehu Zeleke, Judge the FDRE High court
- Interview with, Sosina Alemayehu, Senior Attorney Commercial Bank of Ethiopia
- Interview with, Takele Arega, Director Legal and Loan Recovery, Awash International Bank S.C
- Interview with, Tseada Fantahun, Senior Attorney Commercial Bank of Ethiopia

B. Others[201]

- Guarantee issued by Addis International Bank Hawassa Branch, in favour of Commercial Bank of Ethiopia, dated July 20/2012
- Guarantee issued by Commercial Bank of Ethiopia, in favour of United Bank S.C, dated December 31/2014
- Federal Democratic Republic of Ethiopia, House of people's Representatives, motion number 2/1990 E.C; initiated by the Economic and Legal affairs standing committees of the house, unpublished
- Federal democratic Republic of Ethiopia, House of Peoples Representatives 3rd year of the term 18th meeting minute, Yekatit 12/1990 E.C
- Commercial Bank of Ethiopia Credit Process Procedure

C. News paper Article

- Birhanu Beyene Birhanu, '*The Guarantee Being Out of Use Due to Injunction of Courts*', (translation mine) Reporter Newspaper (Amharic Version) (Addis Ababa, 15 November 2015 V.21 number 1622, column Behege Amlak

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- These instruments are annexed herewith, with the exception of the Commercial Bank of Ethiopia's Credit Procedure