

**SCHOOL OF LAW**  
**ADDIS ABABA UNIVERSITY**



**THE GOVERNING LAW AND JUDICIAL PRACTICE OF DEMAND  
GUARANTEE IN ETHIOPIA: THE CASE OF ROAD CONSTRUCTION**

**BY**

**EYOB ASNAKE AMARE – ID No. GSE/9346/14**

**A THESIS SUBMITTED TO THE SCHOOL OF LAW OF ADDIS ABABA UNIVERSITY  
IN PARTIAL FULFILLMENT OF THE REQUIREMENTS FOR THE DEGREE OF  
MASTER OF LAW (LL. M) IN BUSINESS LAWS.**

**ADVISOR**

**MURADU ABDO (PhD)**

**MARCH 2025**

**ADDIS ABABA ETHIOPIA**

**SCHOOL OF LAW**

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_____	_____	_____
<b>Examiner (Internal)</b>	<b>Signature</b>	<b>Date</b>

## **DECLARATION**

I hereby declare that this LL. M. Thesis represents my original work and that all sources utilized in this thesis are appropriately cited in the references. To the best of my knowledge, this thesis has not been submitted for the award of any degree and is not currently under consideration for any other degree at this university or any other institution.

## ACKNOWLEDGMENT

I want to express my heartfelt gratitude to the supreme God for giving me strength and perseverance throughout this journey. A special thanks to my advisor, Muradu Abdo, whose unwavering support and insightful feedback made completing this thesis possible.

I also appreciate the survey interviewees for generously sharing their time and insights during the data collection process and the institutions that allowed access to essential public documents.

Finally yet importantly, I am deeply grateful to my wife, *Nitsuh*, and my family for their constant encouragement and unconditional love. I truly feel fortunate to have them in my life.

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## **ACRONYMS**

ERA:- Ethiopian Roads Authority

ETCA:- Ethiopian Transport Construction Authority

FIDIC:- International Federation of Consulting Engineers

FSC :- Federal supreme court

ICC:- International Chamber of Commerce

IHA:- Imperial Highway Authority

LC: - Letter of Credit

UCP:- Uniform Customs and Practice for Documentary Credits

UM:- United Nation

UNCITRAL:- UN Commission on International Trade Law

URCG:- Uniform Rules for Contract Guarantees

URDG:- Uniform Rules for Demand Guarantee

## **ABSTRACT**

*Ethiopia continues to engage extensively in road construction, significantly contributing to the nation's economy. However, this sector is inherently high-risk due to its financial demands. To mitigate potential contractual risks, it is essential to adopt effective legal framework that will enhance project performance. One such strategy involves the requirement for contractors to submit a bank demand guarantee in road construction contracts, a standard practice not only in Ethiopia but also in various countries.*

*This demand guarantee, is intended to provide immediate and unconditional payment by the bank should the beneficiary seek compensation due to the non-performance of the contractor. In practice, however, complexities often arise, and timely execution is not guaranteed. Consequently, such guarantees necessitate robust collateral to ensure that banks can fulfill their obligations in the event of the applicant's default. This consideration is particularly important in Ethiopia, where economic and political instability poses a heightened risk of non-payment.*

*By incorporating both doctrinal and empirical research methodologies this research identified that there is no governing law in this respect and judicial practices surrounding demand guarantees cases are not consistent with the international experience.*

**Keywords:** *Demand guarantees, road construction, judicial practices, governing Law, Construction Contracts, non-performance, legal framework, project performance*

# CHAPTER ONE

## 1. General Introduction

All road construction projects aim to adhere to established plans, but practical challenges often disrupt this goal. The complexity of contracts introduces numerous risks, necessitating guarantees. Demand guarantees, provided by financial institutions, offer security by assuring compensation to beneficiaries in case of non-performance.

In Ethiopia, banks commonly issue these guarantees, enhancing confidence in the construction sector through their swift payment capability without disputes. However, there are growing concerns about the obligation to honor all demand guarantee requests, especially in road construction projects. Experts warn that beneficiaries, highlighting the need for governing laws and judicial practices to allow for potential refusal of payment requests, might exploit the independent nature of these guarantees.

This paper aims to explore the existence of such legal frameworks in Ethiopia regarding demand guarantees in road construction. It will assess their effectiveness, identify limitations, and offer recommendations.

The paper is structured into five chapters: Chapter One covers the background, objectives, methods, problem statement, and literature review. Chapter Two defines guarantees, identifies entitled parties, classifies types, and explains principles of demand guarantees. Chapter Three investigates the banking role, relevant Ethiopian legislation, and payment obligations. Chapter Four focuses on construction guarantee disputes in Ethiopia, detailing the importance of guarantees in project stages. Finally, Chapter Five summarizes conclusions and recommendations based on the research findings.

### 1.1 Objectives of the Study

The primary aim of this research is to contribute to the establishment of a supportive legal and judicial framework for demand guarantees in road construction projects. The specific objectives of this study are as follows:

- 1) To identify and analyze the existing legislative gaps those adversely affect construction projects in the context of guarantees.

- 2) To evaluate current court practices and relevant research pertaining to demand guarantee cases.
- 3) To elucidate the distinctions between conditional and demand guarantees as understood by parties involved in construction contracts and the judiciary.
- 4) To advocate for the adoption of a summary procedure by courts for the expeditious resolution of demand guarantee cases.

The outcomes of this study are intended to enhance the effectiveness of the road construction sector by improving project performance and minimizing protracted court litigation.

## **1.2 Background of the Study**

The construction sector represents a substantial component of the Ethiopian economy, with financial involvement reaching billions of birr annually. Within the expansive realm of construction, various structures can be identified, with road construction serving as a significant subcategory of civil engineering. The advancement of the road sector has been prioritized within government policy, as evidenced by the considerable annual budget allocation dedicated to this area.<sup>1</sup>

A multitude of stakeholders participates in this sector, including architects, subcontractors, consulting engineers, material suppliers, and project managers. Nonetheless, the primary actors within this framework are the employers/owners and contractors.<sup>2</sup> These key participants engage primarily through the establishment of construction contracts.

A construction contract is defined as an agreement wherein one party, the contractor, commits to delivering a specific result under their responsibility in exchange for a payment that the other party, the client, agrees to pay.<sup>3</sup> As a result, the contractor is obligated to execute the work in accordance with the stipulations outlined in the contract.

In this regard, the contractor is required to furnish a guarantee to the employer during the execution of the work prescribed by the construction contract. When the employer requests this

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<sup>1</sup> Resettlement/Rehabilitation Policy Framework Road Sector Development Program Support Project (February 2007) p6

<sup>2</sup> John Uff, *Construction Law*, p. 269

<sup>3</sup> Civil Code of the Empire of Ethiopia Proclamation No, 165 /1960 Art, 1676

guarantee and the contractor fulfills this requirement, the security mechanism of the construction guarantee is activated.

A guarantee is articulated as the assurance that a contract or legal obligation will be duly performed. It may also refer to a provision established as security to ensure the compliance with a future commitment or contingent condition. Guarantees frequently manifest as bonds that offer protection against contractual failures.<sup>4</sup>

Murdoch elucidates this concept as follows:

A bond or guarantee is an arrangement under which the performance of a contractual duty owed by one person (A) to another (B) is backed up by a third party (C). What happens is that C promises to pay B a sum of money if A fails to fulfill the relevant duty. In this context A is commonly known as the principal debtor or simply principal; B is called the beneficiary; and C is called the bondsman, surety, or guarantor.<sup>5</sup>

There are two classifications of bonds relevant to construction contracts: conditional bonds and unconditional (or demand) bonds.<sup>6</sup> Conditional bonds are contingent upon a breach of the terms and conditions of the contract; for instance, if the bond is intended to guarantee the contractor's performance, it may not be invoked unless the contractor defaults on their obligations. The beneficiary must furnish proof of both the contractor's failure and any resultant losses to claim payment. Conversely, an unconditional bond allows the employer to demand payment even in the absence of a contract breach, provided there is no evidence of fraud.<sup>7</sup>

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<sup>4</sup> Black's *Law Dictionary* (7<sup>th</sup> ed. West Group St. Paul, Minn 1999)

<sup>5</sup> John Murdoch and Will Hughes, *Construction Contracts Law and management*, (4th ed. Taylor & Francis Group 2008) p. 210

<sup>6</sup> Ibid

<sup>7</sup> Ibid 211-214

These bonding practices are well-established in Ethiopia's road construction sector, where banks provide both conditional and unconditional guarantees for road construction contracts. Conversely, insurance companies predominantly limit their offerings to conditional guarantees.<sup>8</sup>

### **1.3 Statement of the Problem**

This research addresses issues related to unconditional guarantees. When a contractor is awarded a road project, they are typically eligible for an advance payment from the employer.<sup>9</sup> However, before the contractor can utilize this advance payment, they must submit a guarantee bond equivalent to the amount of the advance payment. This bond ensures the repayment of the advance. In most cases, these advance payment guarantees are unconditional.

The contractor is also obligated to provide a performance guarantee to ensure contractual compliance. This performance guarantee can come in the form of bonds issued by banks or insurance companies, and they may be either conditional or unconditional. In this research, we will focus specifically on unconditional performance guarantees.

Upon termination of the construction contract, the employer may call for the bond to be paid unconditionally. Nevertheless, even when the bond is stipulated as an 'Unconditional Guarantee' payable upon first demand, surety banks often hesitate to comply. This can lead to escalating disagreements, ultimately resulting in legal action being filed in a regular court.

Once a case enters the court system and is queued for adjournment, it may evolve into a prolonged full-scale trial. The court will require evidence to support claims of the contractor's nonperformance. A common issue arises when judges confuse unconditional guarantees with conditional guarantees during the adjudication of guarantee bond cases. In the midst of litigation, unconditional guarantee may be treated as conditional, which undermines their intended purpose.

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<sup>8</sup> Prohibition of Issuance of Certain Types of Bonds By Insurance Companies. (Amendment of Insurance Business) Directive No, SUB/24/2004 Art, 2

<sup>9</sup> Federal Government Procurement and Property Administration Proclamation No. 649/2000 Art. 48/1; Federal Public Procurement Directive Ministry Of Finance & Economic Development June/2010 Article 16.26.7

The very essence of a demand guarantee is to facilitate a quick and straightforward realization of the bond, providing coverage for significant risks.<sup>10</sup>

The legal framework governing on-demand guarantees remains unclear. As noted, judges in the Federal High Court tend to apply provisions from the Civil Code related to surety when dealing with demand guarantee bonds. However, the Federal Supreme Court Cassation Division has provided legal interpretation in a relevant case (*Trade Path Int. v. Turkish Airlines & Zemen Bank*).<sup>11</sup> This ruling states that demand guarantees should not be subject to the Civil Code provisions on surety but rather governed by the Uniform Rules for Demand Guarantees (URDG), which serve as the official document for such matters.<sup>12</sup>

#### **1.4 Literature Review**

In conducting a preliminary literature review related to my research topic, I have examined several local sources. This review indicates that previous studies have primarily addressed issues such as the various types of guarantee bonds, the role of surety bonding companies in Ethiopia, and the limitations faced by these companies. Furthermore, this literature has explored the distinctions between surety bonds and guarantee bonds, employing a comparative framework with respect to other legal jurisdictions.<sup>13</sup>

Prior research has inadequately explored the distinctions between a Conditional Guarantee and an Unconditional or Demand Guarantee. A Conditional Guarantee obligates the guarantor to make a payment only upon a breach of the construction contract or another liability of the contractor. In contrast, an Unconditional or Demand Guarantee is payable upon the employer's demand, claiming that a triggering event for payment has occurred. Typically, this type of

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<sup>10</sup> Nino Chipashvili, 'The Banks Guarantee Under The Uniform International Rules' *European Scientific Journal* December (2013) ESJ special ed. vol.1 69

<sup>11</sup> [2019] 05, Nov. 168954 *unpublished*

<sup>12</sup> ICC Uniform Rules for Demand Guarantees, Rule758 July 1, 2010

<sup>13</sup> Bekele Nigussie *Surety Bonds And Companies Rendering Bonding Services In Ethiopia: The Law And The Practice*, (AAU 2004)

guarantee requires the submission of relevant documentation to the guarantor without the need to provide proof of the contractor's breach.<sup>14</sup>

Moreover, the legal framework governing On-Demand Guarantees has not been adequately explored in past studies. In the context of Conditional Suretyship, the provisions within the Civil Code that pertain to this type of transaction are well established. In contrast, the Civil Code of Ethiopia does not specifically address Demand Guarantees. Conditional Surety Bonds function as secondary obligations whose validity is contingent upon the principal obligation of the obligor.<sup>15</sup> Therefore, these bonds are recognized as conditional guarantees. In contrast, Unconditional Guarantees are independent of the underlying contractual obligation and become instantly payable upon demand by the beneficiary.<sup>16</sup>

The continued ambiguity surrounding the existence of a clear legal framework in our jurisdiction governing this type of Guarantee remains an unresolved issue. Consequently, this research aims to contribute additional insights into this subject area.

### **1.5 The Research Question**

The study has attempted to answer the following research questions:-

- 1) Do we have clear legislation governing on-demand guarantees in Ethiopia?
- 2) Are our court decisions and the procedures for resolving unconditional guarantee cases consistent with the Uniform Rules for Demand Guarantees?
- 3) Does the high court in Ethiopia differentiate between demand guarantees and conditional guarantees in its handling of cases?
- 4) Why do banks that issue demand guarantees in Ethiopia prefer litigation instead of making payments upon the first demand of the beneficiary?
- 5) What are the key differences between a demand guarantee and a conditional guarantee?

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<sup>14</sup> Andre Nortje, *Guarantees In Construction Contracts - Some Important Notes*, (Schoeman Law Inc. 2017) 2

<sup>15</sup> Civil Code Art, 1920

<sup>16</sup> Nortje (n 13) 3

## **1.6 Hypothesis of the Study**

The decisions rendered by the federal high court concerning disputes related to unconditional guarantee bonds in the context of road construction appear to lack consistency with the Uniform Rules for Demand Guarantees (URDG) and the Cassation decisions of the Federal Supreme Court of Ethiopia. Additionally, the legal framework governing demand guarantees in Ethiopia is characterized by ambiguity and lacks definitive clarity.

## **1.7 The Research Method**

This study employs a mixed-methods approach, incorporating both doctrinal and empirical research methodologies. Given the nature of the research topic, which seeks to examine the governing law of demand guarantees within Ethiopia's legal framework, a doctrinal research approach is essential. To achieve this, both primary and secondary sources of data have been utilized. Primary sources include authoritative legal documents such as the Constitution, proclamations, regulations, directives, and decisions from the Federal Supreme Court (FSC). Secondary sources comprise non-binding legal materials, including commentaries, academic journals, legal dictionaries, other court decisions, institutional reports, and encyclopedias.

The collected data are subjected to rigorous analysis employing legal reasoning and analytical tools. The inquiries within this research seek to uncover the legal rules that are shaped by both legal positivism and legal realism within the theoretical framework.

The second dimension of the research, pertaining to judicial practice, lends itself to empirical investigation. Judicial practice is interpreted through the lens of decisions rendered by specific courts in disputes involving demand guarantees. Data have been collected from selected court decisions, particularly from the Federal High Court's Lideta Division Construction Bench concerning demand guarantee cases filed by Road Construction Limited, focusing on the period commencing from 2011 Ethiopian Calendar onward. This temporal focus arises from the political instability experienced in Ethiopia in the preceding five to four years, during which issues such as the cessation of road projects, contract terminations, and the invocation of demand guarantees by surety banks were prevalent. Consequently, cases related to guarantees came to dominate this court's docket.

To test the hypotheses underpinning this research, specific criteria have been applied, including the assessment of cases resolved under expedited procedures and those adjudicated in alignment with the Uniform Rules for Demand Guarantees (URDG) and FSC cassation decisions. A random sampling technique has also been implemented throughout this research. Based on the evidence derived from the collected data, conclusions will be drawn employing deductive reasoning methodologies.

### **1.8 The Scope of the Study**

This study focuses on road construction in Ethiopia. To ensure manageability and accessibility, it is specifically limited to unconditional/demand guarantees within this context.

### **1.9 Significance of the Study**

In addition to fulfilling the outlined objectives, it is hoped that this study has the following significance:

- It presents findings on the existence of governing laws related to demand guarantees in Ethiopia.
- It aims to raise awareness regarding the applicable legal framework governing demand guarantees and its effectiveness in road construction.
- The study also provides recommendations to address existing gaps in regulatory rules that need to be considered and implemented.
- Finally, it serves as a foundational document for other researchers interested in further exploring this area and conducting more in-depth studies on the subject.

## CHAPTER TWO

### 2. INTRODUCTION

In this part of the study, different literature related to the area of the research are reviewed and described. First, concepts and operational definition are explained. Next literature concerning demand Guarantee is reviewed and, finally the development of the theoretical framework to be tested in the study in presented.

#### 2.1 Guarantee in General

The task of defining the term "Guarantee" with a single word or synonym may initially seem straightforward. Its origins trace back to the Latin phrases '*garantia*' or '*garandia*', which signify "to protect" or "to defend." Historical literature often addresses the concept of a guarantee in relation to the "warranty" of land titles.<sup>17</sup> Suretyship, a concept that has endured through time, is well-documented in historical texts such as the Bible, the Code of Hammurabi, and the Magna Carta.<sup>18</sup> In contrast, the lexical definition of guarantee designates it as "*an undertaking to answer for the payment of a debt or the performance of a duty of another in the event of the other party's default or nonperformance.*"<sup>19</sup>

Legal usage of the term began to crystallize in the late eighteenth century. A notable legal phenomenon related to this is the statute of frauds,<sup>20</sup> which elucidates what is recognized today as a "guarantee," defining it as a particular promise to assume responsibility for another party's debt or obligation. Consequently, a guarantee is most effectively comprehended within the framework of contractual relationships among the parties involved. It serves as a mechanism of

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<sup>17</sup>Max Radin, Guarantee and Suretyship; California Law Review, Sep. 1929, Vol. 17, No. 6 (Sep. 1929), pp. 605-622 California Law Review, Inc.pp.605) Mark F. Openshaw, Surety Bonds And Sureties In The Construction Industry

<sup>18</sup>Mark F. Openshaw, Surety Bonds And Sureties In The Construction Industry

<sup>19</sup> Merriam-Webster Dictionary.

<sup>20</sup> The statute of frauds is a foundational principle of common law that requires – for them to be enforceable – some types of contracts to be written rather than merely oral agreements. It is a longstanding and well-established legal principle, originating in 17th-century English law.

contractual security for creditors, affording them the right to seek fulfillment from multiple individuals, thereby mitigating the risk of default.<sup>21</sup> The essential components of a guarantee encompass at least two contracts: the principal contract and an auxiliary contract, which constitutes the guarantee. This arrangement involves three distinct classes of participants: the creditor, the principal debtor, and the guarantor, each holding different interests and positions relative to one another.<sup>22</sup>

## **2.2 Guarantee and Suretyship**

The concepts of Guarantee and Suretyship are frequently regarded as synonymous. Many legal systems adopt this perspective, employing these terms interchangeably. However, certain jurisdictions differentiate between the two. For instance, various states in the United States have instituted specific statutes delineating the legal prerequisites for guarantees and sureties within their respective jurisdictions.<sup>23</sup> Some jurisdictions maintain a distinction between Suretyship and guarantees, while others have effectively abolished such differences. Examples of states that no longer differentiate between a guarantee and a surety include California, Texas, Pennsylvania, Georgia, Oklahoma, and South and North Dakota. Notwithstanding these distinctions, both concepts require the existence of a valid principal obligation between the debtor and the creditor, as well as an accompanying contract between the surety or obligor and the creditor.<sup>24</sup>

In contrast, the Civilian legal tradition differentiates between these two concepts based on their varied historical usage and prevalence. The term "Guarantee," in its connotation of "Warranty," has enjoyed longstanding application in transactions involving lands and chattels. Nonetheless,

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<sup>21</sup> Christopher Henkel, Personal Guarantees and Sureties between Commercial Law and Consumers in the United States *The American Journal of Comparative Law*, Vol. 62, SUPPLEMENT: U.S. National Reports to the XIXth International Congress of Comparative Law in Vienna, Austria, 2014 (2014), pp. 333-359

<sup>22</sup> Ralph Slovenko, Effects of Suretyship *The American Journal of Comparative Law*, Winter, 1960, Vol. 9, No. 1 (Winter, 1960), pp. 48-77 Published by: Oxford University Press

<sup>23</sup> Christopher Henkel Personal Guarantees and Sureties between Commercial Law and Consumers in the United States *The American Journal of Comparative Law*, Vol. 62, SUPPLEMENT: U.S. National Reports to the XIXth International Congress of Comparative Law in Vienna, Austria, 2014 (2014), pp. 333-359

<sup>24</sup> *Ibid*

as previously mentioned, "Guarantee" assumed its contemporary designation as a "special promise" within the context of the Statute of Frauds around the eighteenth century. In contrast, Suretyship, as a third-party commitment to compensate for another's default, has served as a prominent security mechanism that has existed at least since the thirteenth century.

### 2.3 Types of Securities

In the field of commerce, ensuring the security of transactions is a primary concern for all parties involved. An effective and equitable system of secured transactions is essential for a credit market, facilitating easy access to the lending and borrowing processes for everyone.<sup>25</sup> Guarantees, as instruments for securing the fulfillment of contractual obligations, can be broadly categorized into two main types: real securities and personal securities.<sup>26</sup>

Real securities encompass all corporeal and incorporeal property rights used to secure a transaction through methods such as pledges, mortgages, and antichresis. In contrast, personal securities refer solely to the personal obligations of the debtor. According to Black's Law Dictionary, security is defined as:

- 1) *Collateral provided or pledged to ensure the fulfillment of an obligation; specifically, the assurance that a creditor will be repaid (usually with interest) for any money or credit extended to a debtor.*
- 2) *An individual bound by some form of guarantee, or surety.*<sup>27</sup>

This paper focuses specifically on personal guarantees or Suretyship. A personal guarantee indicates that a third party commits to fulfilling the debtor's obligation in the event of the debtor's default. More precisely, the research will concentrate on the Suretyship of a juridical person. By

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<sup>25</sup> Asress Adimi Gikay, Rethinking Ethiopian Secured Transactions Law through Comparative Perspective: Lessons from the Uniform Commercial Code of the US Mizan Law Review Vol. 11 No.1 (2017) p12

<sup>26</sup> Christopher Henkel, Personal Guarantees and Sureties between Commercial Law and Consumers in the United States The American Journal of Comparative Law, Vol. 62, SUPPLEMENT: U.S. National Reports to the XIXth International Congress of Comparative Law in Vienna, Austria, 2014 (2014), pp. 12

<sup>27</sup> Black's Law Dictionary Seventh Edition Bryan A. Garner Editor in Chief WEST GROUP ST. PAUL, MINN., 1999

the theory of *fiction*,<sup>28</sup> both natural persons and juridical persons can serve as personal guarantors. This concept leads to the idea of corporate Suretyship. Corporate sureties are financial institutions that specialize in providing surety bonds. Unlike personal Suretyship, corporate sureties emerged during the Industrial Revolution.<sup>29</sup>

## 2.4 Bank Guarantees

Modern commercial transactions necessitate various security instruments to ensure the fulfillment of contractual obligations among parties involved.<sup>30</sup> In the traditional banking environment, banks extend credit to borrowers secured by real or personal securities provided by those borrowers. In this capacity, the bank holds the position of a creditor or beneficiary.<sup>31</sup> However, in the context of a guarantee contract, the bank assumes the role of a debtor to the beneficiary of the guarantee. Here, the bank's obligation is confined exclusively to the payment of a specified sum of money.<sup>32</sup>

A bank guarantee represents a type of institutional guarantee or Suretyship, which implies the involvement of a bank as a personal guarantor in the transaction. Vasile Nemeş aptly defines a bank guarantee as,

It is a kind of legal Technique and it is an irrevocable commitment of a bank entity towards a determined person, through which guarantees a certain legal conduct of its client, and, in case of breach, assumes the payment obligation of a determined amount of money. In the usual business language, it is called a "Letter of Bank Guarantee".<sup>33</sup>

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<sup>28</sup> Elvia Arcelia Quintana Adriano, *The Natural Person, Legal Entity or Juridical Person and Juridical Personality*, 4 PENN. ST. J.L. & INT'L AFF. 363 (2015).

<sup>29</sup> Willis D. Morgan, *History and Economics of Suretyship*, 12 Cornell L. Rev. 153 (1927) p12 Available at: <http://scholarship.law.cornell.edu/clr/vol12/iss2/2>

<sup>30</sup> P.M. Bakshi *BANK GUARANTEES* Journal of the Indian Law Institute, January-March 1995, Vol. 37, No. 1 (January-March 1995), pp. 109-111: Indian Law Institute

<sup>31</sup> The old Commercial Code Art, 947

<sup>32</sup> Vasile Nemeş. "BANK GUARANTEES". LESIJ - Lex ET Scientia International Journal 2:128- 136

<sup>33</sup> Ibid

Traditional banking services predominantly consist of collecting and depositing funds, subsequently making them available to borrowers. In addition, banks are recognized for providing documentary guarantees. Historically, it was common practice in both international and local transactions to require a cash deposit as security to ensure the counterparty's commitment to fulfilling their obligations.<sup>34</sup> As the complexity of business transactions increased, the need for documentary guarantees emerged to address the liquidity challenges faced by business entities.<sup>35</sup> Consequently, banks began offering various types of documentary guarantees in exchange for cash security.

In summary, bank guarantees serve to assure the performance and payment obligations of the principal debtor. As an efficient security measure, bank guarantees offer significant advantages over other security devices; unlike real securities, a bank guarantee does not involve tangible property nor does it limit potential revenue.<sup>36</sup>

## **2.5 Types of Guarantees**

The primary types of guarantees include tender guarantees or bid bonds, performance guarantees or completion bonds, advance payment guarantees or repayment guarantees, retention guarantees, and maintenance guarantees, among others. These guarantees may be categorized as conditional or unconditional.

Despite the extensive discourse surrounding the concept of bank guarantees in legal literature, the status of bank guarantee or bond documents remains ambiguous within the legal framework of contracts. This ambiguity raises several questions, including whether such documents are contractual or merely letters from the bank, whether bank guarantees are analogous to personal

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<sup>34</sup> Post-dated bills of exchange were also sometimes used, but due to the risk of non-payment, this practice was not popular, and cash deposits that guaranteed payment were preferred. See also R 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* 3 ed (2004) at 2

<sup>35</sup> Michelle Kelly-Louw *Selective Legal Aspects of Bank Demand Guarantees*, submitted in accordance with the requirements for the degree of Doctor of Laws at the University of South Africa

<sup>36</sup> *Bank Guarantees and their Representation in Bank Business Activities (Parallel Legal Presentation)* Mirjana Knezević, Aleksandar Lukić)

guarantees, and what the legal frameworks governing demand bank guarantees entails? The inquiries are examined in Chapter Four.

## 2.6 Demand Guarantees

Based on the relationship between the principal contract and the guarantee contract, which is considered an accessory obligation— there, exist two types of guarantee contracts, namely conditional and demand guarantees.<sup>37</sup> The defining characteristic of a guarantee is its ancillary nature. This accessory feature is a common attribute shared by both demand and conditional guarantees, with the primary distinction being the condition required to establish the principal debtor's failure by the beneficiary. In the case of a conditional guarantee or Suretyship, the beneficiary must demonstrate the principal debtor's default in order to claim payment. Conversely, the beneficiary of a demand guarantee possesses the right to request payment upon simple demand, either without justification or with the provision of one or more specified documents.<sup>38</sup>

In legal and academic discussions, demand guarantees are referred to by various terms, including independent guarantees, first demand guarantees, and unconditional guarantees. Some scholars equate demand guarantees with Standby Letters of Credit, as they fulfill similar economic functions.<sup>39</sup> A demand guarantee represents the simplest and most straightforward form of guarantee due to its extra-judicial and self-executing characteristics. The specified amount on the document is payable to the beneficiary upon the first demand, without any defenses or conditions, except in cases of fraud.<sup>40</sup>

In practice, the majority of demand guarantees are activated in two scenarios: "first written demand" or "simple demand." In its most basic form, a simple demand guarantee permits the beneficiary to request payment in any manner, including orally, at any time during the validity

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<sup>37</sup>Ibid

<sup>38</sup>Eric E. Bergsten A New Regime for International Independent Guarantees and Stand-by Letters of Credit: The UNCITRAL Draft Convention on Guarantee Letters *The International Lawyer*, Winter 1993, Vol. 27, No. 4 (Winter 1993), pp. 859- 879 American Bar Association

<sup>39</sup>Ibid

<sup>40</sup> Ibid n 14, 111

period of the guarantee without the necessity of justifying the legitimacy of the demand.<sup>41</sup> If the guarantee stipulates specific documentation for the request, such documentation may include a statement from the beneficiary confirming that the principal debtor has failed to comply with their obligations or a statement from a third party to that effect. At this stage, upon receipt of the simple demand, the guarantor is obligated to act accordingly.<sup>42</sup>

The primary objective of a demand guarantee is to facilitate the immediate recovery of the Beneficiary from financial losses incurred due to the non-performance of the underlying contract by the Principal debtor. The principle of "pay now and litigate later" emerges from this rationale. Engaging in litigation or arbitration over the legitimacy of invoking the guarantee by the Beneficiary incurs significant time and expense. Furthermore, it delays the realization of the amount designated in the document, which could be crucial for maintaining the continuity of contractual performance by an alternative contractor.<sup>43</sup> As a result, a pivotal distinction between demand guarantees and traditional guarantees exists; in the latter case, the Beneficiary is required to substantiate the default of the Principal, which typically serves as a prerequisite.

## **2.7 Demand Guarantees in Ethiopia**

In Ethiopia, banks and insurance companies serve as the primary issuers of documentary guarantee bonds, whether in conditional or demand form. Unlike many other jurisdictions, there is not yet a specialized institution dedicated to this service.<sup>44</sup> The provision of corporate Suretyship and guarantee bonds by financial institutions can be traced back to their introduction into the Ethiopian commercial landscape in 1905.<sup>45</sup> Similar to other conventional banking services, a corporate client may obtain a bank guarantee to fulfill its obligations towards a creditor within a principal contract. Most guarantee bond documents are issued in favor of the Beneficiary. It is the responsibility of the Beneficiary to direct an account party to provide either

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<sup>41</sup> Eric E Bergsten 'A New Regime for International Independent Guarantees and Stand-by Letters of Credit: The UNCITRAL Draft Convention on Guarantee Letters' (1993) 27 International Lawyer 859 at 868.

<sup>42</sup> Ibid

<sup>43</sup> N 18, 20

<sup>44</sup> Bekele Nigussie *Surety Bonds And Companies Rendering Bonding Services In Ethiopia: The Law And The Practice*, (AAU 2004). 134

<sup>45</sup> Belai Giday, *Currency & Banking: Ethiopia* (1987), p. 68

a conditional or demand guarantee bond according to its interests regarding the security of mutual contractual obligations.

In practice, various formats of guarantee documents are prevalent. Some may be drafted by the account party and presented for the Guarantor's signature, while others might be prepared by the Guarantor and require only the account party's consent.<sup>46</sup> Additionally, some account parties opt for guarantees that incorporate the ICC Uniform Rules for Demand Guarantees, which are accepted by certain guarantors, particularly the Commercial Bank of Ethiopia.<sup>47</sup>

The methods utilized can vary across different sectors. In the construction industry, especially in road construction, the FIDIC model contract is commonly employed. This model contract specifies a recommended format (template) for the guarantee document, necessitating adherence from the contractor.<sup>48</sup>

Bank guarantees and insurance bonds—such as bid bonds, performance bonds, and advance payment bonds—have become standard practice, corresponding to nearly all commercial contracts. Nevertheless, a significant challenge associated with demand guarantees is the tendency of guarantors (banks or insurance companies) to delay responses to the initial demands of beneficiaries. In numerous instances, payment arises only through judicial or arbitral proceedings following the invocation of a demand guarantee. A bank's failure to pay a demand guarantee upon the first request from the beneficiary constitutes a breach of contract.<sup>49</sup> However, this situation may arise due to the substantial amount of money involved, liquidity constraints, the time value of money, and the minimal collateral value. Consequently, some beneficiaries have instituted a mechanism for the so-called blacklisting of bond-issuing institutions. Under this blacklisting procedure, the historical repayment behavior of a guarantor is critically assessed; if

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<sup>46</sup> N 28, 138

<sup>47</sup> Ibid

<sup>48</sup> FIDIC Conditions of Contract for Construction Work

<sup>49</sup> All Interviewed bank legal directors agree with this proposition

the historical precedent is unfavorable, the guarantor is automatically blacklisted, leading to the rejection of any future bonds issued by that guarantor in favor of that specific beneficiary.<sup>50</sup>

## **2.8 Summary**

This chapter reviews literature related to guarantees, defining key concepts and operational definitions. It examines the historical context and legal framework surrounding guarantees and Suretyship. The term "guarantee" originates from Latin words meaning "to protect" or "to defend." It refers to an undertaking to answer for another person's debt or obligation in the event of default. Legal definitions of guarantees were established in the late 18th century, primarily through the Statute of Frauds.

While "guarantee" and "Suretyship" are often used interchangeably, some jurisdictions make a distinction between the two. Different legal traditions have unique historical applications for each term. Guarantees are categorized into two types: real securities (which involve property rights) and personal securities (which involve debtor obligations). This paper focuses on personal guarantees or Suretyship, with a particular emphasis on corporate Suretyship. Bank demand guarantees are defined as irrevocable commitments made by banks to pay a specified amount upon demand.

In Ethiopia, demand guarantees are primarily issued by banks and insurance companies, with a historical context dating back to 1905. Various formats of bank guarantees exist, and the FIDIC model contract is commonly used in construction projects. Challenges in this area include delays in responses from guarantors, which can lead to potential blacklisting of institutions based on their historical performance.

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<sup>50</sup> Interview with Ato Samuel Kiflu, an Acting Director of the Legal Affairs Service Directorate in ERA(Addis Ababa, Ethiopia 7 Dec, 2023)

## CHAPTER THREE

### 3. OVERVIEW OF BANK DEMAND GUARANTEE LAW

At the global level, the historical evolution of bank demand guarantees is closely linked to the development of documentary credits. The commercial practices and customary usages among traders in the early nineteenth century significantly contributed to the advancement of the law governing documentary credits.<sup>51</sup> In recent times, the legal frameworks that apply to demand guarantees within the realm of international business have seen significant development, surpassing those in domestic contexts.<sup>52</sup> In many national legal systems, it is often challenging to locate explicit statutory provisions that govern demand guarantees.

Nonetheless, prevailing practices indicate that commercial disputes arising from these instruments are typically resolved through the application of clear contractual provisions, unwritten rules, general principles of contract and commercial and case law.<sup>53</sup> The transnational nature of these transactions necessitates a coordinated international response from the global legal framework. The global initiative entitled "harmonization of laws"<sup>54</sup> has given rise to range of model laws in this domain: the United Nations Convention on Independent Guarantees and Standby Letters of Credit, the Uniform Rules for Demand Guarantees (URDG) promulgated by the International Chamber of Commerce (ICC), and the ISP98

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<sup>51</sup>Michelle Kelly-Louw Selective Legal Aspects of Bank Demand Guarantees, submitted in accordance with the requirements for the degree of Doctor of Laws at the University of South Africa p93

<sup>52</sup>Eric E Bergsten 'A New Regime for International Independent Guarantees and Stand-by Letters of Credit: The UNCITRAL Draft Convention on Guaranty Letters' (1993) 27 International Lawyer 859 at 868 p6)

<sup>53</sup> Ibid n 1

<sup>54</sup> The establishment, in 1926, of the International Institute for the Unification of Private Law (UNIDROIT ) came at a time when the ideal of legal unification seemed unquestionable. Those early years of institutionalized legal harmonization have been referred to as "the republic of scholars", and in fact, the early work of U NIDROIT was developed "in an unconstrained, truly academic discourse among experts." José Angelo Estrella Faria, Future Directions of Legal Harmonization and Law Reform: Stormy Seas or Prosperous Voyage

### **3.1 The ICC's Rules**

Since 1933, the International Chamber of Commerce (hereinafter referred to as 'ICC') has been involved in drafting and issuing the Uniform Customs and Practice for Documentary Credits (hereinafter referred to as 'UCP').<sup>55</sup> The UCP comprises a set of rules that are regularly revised and updated by the ICC.<sup>56</sup> The various versions of the UCP have evolved from the initial edition to the most recent. Despite these ongoing revisions, the UCP did not explicitly address standby letters of credit until the 1983 version.<sup>57</sup> Prior to that, it was common practice to issue a standby letter of credit referencing the 1962 and 1974 versions of the UCP. It is noteworthy that substantial portions of the UCP are incongruent with the standby letter of credit and, by extension, demand guarantees. This inconsistency arises primarily because the UCP was originally drafted with a focus on traditional documentary credits, which were intended primarily for international sales transactions involving documentary credits as a method of payment.<sup>58</sup>

Despite these limitations, the UCP has remained the exclusive set of rules governing standby letters of credit and demand guarantees for a considerable period.<sup>59</sup>

### **3.2 Uniform Rules for Contract Guarantees (URCG)**

The URCG aims to provide assurances concerning tender, performance, and repayment in international trade contracts. Published by the International Chamber of Commerce (ICC) in 1978 after twelve years of dedicated effort, this instrument serves as a collection of guiding principles rather than binding regulations.<sup>60</sup> The parties involved in a contract are bound by these rules only if they explicitly incorporate them into the transaction or make a clear reference to their application.

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<sup>55</sup> ICC Publication, No 82, Paris (1933)

<sup>56</sup> J F Dolan 'The UN Convention on International Independent Undertakings: Do States with Mature Letter-of-Credit Regimes Need It?' (1998) 13 Banking and Finance Law Review 1 at 2). The 1993 version was similarly revised and promulgated in 2007.

<sup>57</sup> R Bertram 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

<sup>58</sup> Ibid n 1p 103

<sup>59</sup> Ibid

<sup>60</sup> Ibid 108

According to Article 1 of the URCG, these rules apply to any guarantee, bond, indemnity, surety, or similar undertaking, regardless of the terminology used, which specifies that it is governed by the Uniform Rules for Tender, Performance, and Repayment Guarantees (Contract Guarantees, ICC Publication No. 325). These rules are binding upon all parties unless otherwise expressly stated in the guarantee or any amendments thereto.

The URCG introduces distinctive features concerning demand guarantees in comparison to their predecessors and successors. Article 9 stipulates that the calling of a guarantee is deemed reasonable only when the claim is substantiated by appropriate documentation that demonstrates the default of the principal. Such documentation may include a court judgment, an arbitral award, or the principal's written consent regarding the claim and its amount. Consequently, court litigation or an arbitral proceeding, acts as an essential condition precedent for the beneficiary. The outcome of the litigation must unequivocally establish the principal's default. Therefore, simple on-demand or first-demand guarantees fall outside the scope of the URCG.<sup>61</sup>

Moreover, the instrument differentiates between simple on-demand guarantees and demand guarantees. While all demand guarantees are payable upon demand, the term "on-demand guarantee" typically suggests that the only condition for payment lies in the beneficiary's simple request. Such guarantees are often referred to as "unconditional guarantees."<sup>62</sup> However, the term "unconditional" may lack clarity, as certain conditions precedent may be required. For instance, payment might only be processed if the claim is submitted prior to the guarantee's expiration date. Thus, parties intending to enter into an on-demand guarantee should consider excluding Article 9 of the URCG from their guarantee contract. This limitation significantly affects the URCG's acceptability, particularly among importers, as it undermines the fundamental objective of demand guarantees, which is to provide an expedited financial remedy for beneficiaries.

### **3.3 Uniform Rules for Demand Guarantees (URDG)**

The practical limitations encountered by the Uniform Rules for Contract Guarantees (URCG) necessitated a renewed initiative for the amendment of the rules they encompass. In 1985, the British Banking Association submitted a draft Code of Practice for Contract Guarantees or

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<sup>61</sup> Ibid 109

<sup>62</sup> id

Bonds to the International Chamber of Commerce (ICC) for deliberation. Building upon this foundation, the ICC developed a detailed set of Uniform Rules that specifically addressed the inclusion of first-demand guarantees.<sup>63</sup> The United Nations Commission on International Trade Law (UNCITRAL) Working Group on International Contract Practices has also contributed by reviewing the draft rules and recommending various changes and enhancements.

However, the project has faced unforeseen challenges from various stakeholders. A primary concern during the drafting process was to balance the competing interests of banks, exporters, and industrialized nations against the rights of both principals and beneficiaries. Following an extensive process, the URDG was officially endorsed by the ICC in December 1991 and published in April 1992.

The URDG N 458 introduced two critical rules. Firstly, with the beneficiary's best interests in mind, the majority of documentary guarantees are payable upon first written demand, irrespective of supporting documents. Secondly, to protect the principal's business interests, the unjustified calling of demand guarantees by the beneficiary is prohibited under this instrument.<sup>64</sup>

### **3.3.1 The Application and Acceptance of URDG**

The fundamental characteristic of a demand guarantee lies in its independence from the main contract. This indicates that a demand guarantee is not an accessory obligation. Article 2(b) of the URDG N 458 affirms the independence of the guarantees to which the URDG applies: *"Guarantees by their nature are separate transactions from the contract(s) or tender conditions on which they may be based."* This distinction explains why the URDG is incompatible with Suretyship conditional bonds or guarantees and other accessory undertakings, wherein the guarantor's obligation to pay arises solely upon the actual default by the principal.<sup>65</sup> Although such security devices are in common use, they fall outside the URDG's scope and purpose due to their differing nature from demand guarantees.<sup>66</sup>

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<sup>63</sup> ibid

<sup>64</sup> the Guide to the URDG

<sup>65</sup> Ibid

<sup>66</sup> the 'Introduction' to the URDG

The URDG serves as a model contract for guarantees, the acceptance of which depends upon the consent of the contracting parties. The principle of freedom of contract allows the parties to delineate the objects of their agreement. Parties are at liberty to determine that their relationship will be governed by a set of standard terms within the contract. The URDG is applicable to any demand guarantee that explicitly stipulates its subjection to these rules.<sup>67</sup>

Nonetheless, the URDG N 458 experienced commendable success only from 1992 to 2009. To replace its predecessor, the more comprehensive, clear, and precise URDG N 758 came into force. Currently, the URDG N 758 has achieved international acceptance among banks. Moreover, various legislative bodies incorporate the URDG as a model for drafting independent guarantee statutes within their domestic legal frameworks. The International Federation of Consulting Engineers (FIDIC) has adopted the URDG as its model guarantee form under the 1999 Conditions of Contract.<sup>68</sup> The World Bank similarly followed suit in 2002.

### **3.3.2 The Main Features of Demand Guarantee under URDG N 758**

The newly enacted URDG N 758 has introduced several advanced provisions that enhance business transactions. This discussion will focus specifically on two key features.

#### **3.3.2.1 Independent Legal Nature of the Guarantee**

Article 5 of the URDG delineates the independence of the guarantee as follows:

A guarantee is by its nature independent of the underlying relationship, and the application and the guarantor are in no way concerned with or bound to such relationship. A reference in the guarantee to the underlying relationship for identifying it does not change the independent nature of the guarantee. The undertaking of a guarantor to pay under the guarantee is not subject to claims or

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<sup>67</sup> Uniform Rules for Demand Guarantees (URDG 758) 2010 ICC publication, article 1

<sup>68</sup> Red book, Conditions of contract for construction for building and engineering works designed by the employers, Annex A to G

defenses arising from any relationship other than a relationship between the guarantor and the beneficiary.<sup>69</sup>

From a legal perspective, the independence of a guarantee contract implies that it remains unaffected by challenges stemming from the underlying relationship. Consequently, the guarantor's obligation to the beneficiary remains valid even if the underlying agreement, which the guarantee secures, is found to be void. A demand guarantee operates as an independent transaction governed by its specific terms.<sup>70</sup> Moreover, the principle of independence is reinforced by rejecting the concept of set-off, as articulated in the provision stating that *a guarantor's obligation is not subject to claims or defenses beyond the relationship with the beneficiary*.

However, it is important to note that the independence of a demand guarantee is not an absolute principle. Established fraud serves as a recognized international exception to the autonomy rule that typically isolates demand guarantees from the underlying contract.<sup>71</sup> This fraud exception applies solely in cases where there has been an unjustified call on the guarantee by the beneficiary or their agent. In such circumstances, the guarantor may refuse payment, and the principal may resort to injunction proceedings against either the bank to prevent payment or the beneficiary to inhibit any demand or receipt of payment.<sup>72</sup>

This exception to the autonomy principle does not solely arise from uniform international rules; rather, it often stems from legal principles applied by courts according to the relevant law governing the guarantee, which may include domestic law considerations.<sup>73</sup>

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<sup>69</sup> URDG N 758

<sup>70</sup> Nino Chipashvili, THE BANKS GUARANTEE UNDER THE UNIFORM INTERNATIONAL RULES European Scientific Journal December 2013 /SPECIAL/ edition vol.1 p71

<sup>71</sup> N Enonchong 'The autonomy principle of letters of credit: an illegality exception? (2006) Lloyd's Maritime and Commercial Law Quarterly at 404

<sup>72</sup> Michelle Kelly-Louw illegality as an exception to the autonomy principle of bank demand guarantees The Comparative and International Law Journal of Southern Africa , NOVEMBER 2009, Vol. 42, No. 3 (NOVEMBER 2009), pp. 339-386

<sup>73</sup> Ibid

### 3.3.2.2 Guarantee and Force Majeure

The recently introduced rule concerning force majeure under URDG N 758 delineates specific events that qualify as force majeure, encompassing “*acts of God, riots, civil commotions, insurrections, wars, acts of terrorism or any causes beyond the control of the guarantor or counter-guarantor that interrupt its business as it relates to acts a kind subject to these rules.*”<sup>74</sup>

The operation of this force majeure rule can be examined through two scenarios.

The first scenario pertains to the interests of the beneficiary. It stipulates that if the term of the guarantee expires at a time when the submission of a demand or payment is thwarted due to force majeure, the term of the guarantee shall be extended by 30 calendar days from the original expiration date. In this context, the guarantor is obligated to notify the instructing party of the occurrence of the event. Should the guarantor accept the documents submitted by the beneficiary yet be unable to perform an inspection due to force majeure circumstances, the inspection period shall be suspended until the resumption of the guarantor's activities.

Furthermore, if the guarantor has inspected the documents but payment is delayed due to force majeure, the payment must be executed once the force majeure event concludes, even if the guarantee's term has expired. The instructing party remains bound by any extensions, suspensions, or payments as outlined in Article 26 of URDG N 758. The guarantor does not assume any additional liability for the repercussions of the force majeure event.<sup>75</sup>

### 3.4 UN Convention On Independent Guarantees And Stand-By Letters Of Credit

From 1988 to 1995, UNCITRAL<sup>76</sup> engaged in a drafting process for the Uniform Rules for International Guarantees. Prior to this period, UNCITRAL had recommended the application of the Uniform Customs and Practice for Documentary Credits (UCP), which was developed by the ICC. Additionally, UNCITRAL actively participated in the revision of the UCP and encouraged the ICC to create a comparable set of rules governing guarantees.<sup>77</sup> In a notable development,

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<sup>74</sup> URDG N 758 Art,26 paragraph b

<sup>75</sup> Ibid

<sup>76</sup> See the ‘UNCITRAL Explanatory Note.’

<sup>77</sup> Eric E. Bergsten A New Regime for International Independent Guarantees and Stand-by Letters of

UNCITRAL introduced its own Convention in 1995, addressing demand guarantees and standby letters of credit.<sup>78</sup> This situation raises questions regarding the redundancy of efforts by two international institutions to address similar projects.<sup>79</sup> Some analysts have suggested that delays in the ICC's drafting process for URDG prompted UNCITRAL to initiate its own project aimed at formulating demand guarantee rules.<sup>80</sup> Despite the overlap, the UN Convention possesses distinctive features worthy of discussion.

### 3.4.1 The Application of the Convention

Treaties or Conventions serve as primary legal sources for demand guarantees in international transactions. A sovereign state may choose to become a signatory to this convention or incorporate its principles within its legal framework. In the absence of such adoption, individual parties involved in demand guarantee contracts may include clauses that reference the application of these instruments to their particular transaction.

Fundamentally, the UNCITRAL Convention on Independent Guarantees and Standby Letters of Credit is governed by the law of treaties.<sup>81</sup> Therefore, the regulations outlined in the UNCITRAL are applicable to international undertakings in principle.<sup>82</sup> The Convention also defines a demand guarantee as an *independent commitment* concerning international demand guarantees or standby letters of credit.<sup>83</sup> Article 4 elaborates on the “international character of the undertaking,” specifying that “*an undertaking is deemed international if the places of business indicated in the undertaking for any two of the listed parties (guarantor/issuer, beneficiary, principal/applicant, instructing party, or confirmer) are situated in different states.*” Thus, the UNCITRAL Convention exclusively applies to independent undertakings of international origin. Recently,

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Credit: The UNCITRAL Draft Convention on Guaranty Letters

<sup>78</sup> The UNCITRAL Explanatory Note op cit note 195 in note 1 at 13. For a full discussion of the UNCITRAL Convention see L Gorton ‘Draft UNCITRAL Convention on Independent Guarantees’ (February 1996) Lloyd’s Maritime and Commercial Law Quarterly 42; Gorton op cit note 7

<sup>79</sup> U.N. Doc. A/CN.9/301, 191

<sup>80</sup> n 1 p 125

<sup>81</sup> The Vienna convention on the law of Treaties in 1969

<sup>82</sup> UNICITRAL Convention on Independent Guarantees and Stand-By Letters of Credit (UNICITRAL) article 1

<sup>83</sup> Ibid

there has been increasing interest in extending the Convention's scope to encompass domestic transactions, permitting parties to a domestic guarantee letter to opt for the Convention's application by explicitly stating that the letter is subject to it.<sup>84</sup>

Another fundamental characteristic of the UNCITRAL Convention is its enacting agency. In contrast to the UCP and URDG, which are drafted by the ICC as voluntary rules or self-regulatory measures, the Convention is composed by UNCITRAL as a uniform law or official regulation for adoption by countries.<sup>85</sup> Therefore, the Convention shall integrate into the domestic laws of adopting states. Additional features of the Convention will be examined in Chapter Four.

### **3.5 The ISP98 Rules**

ISP98 (International Standby Practice) constitutes an international framework of regulations that delineate the rights and responsibilities of parties engaged with standby letters of credit. These guidelines have been formulated by the ICC and are applicable when the parties involved in a standby letter of credit explicitly adopt them.<sup>86</sup> The most recent iteration of these rules, documented as ICC Publication No. 590, was implemented in 1999 and encompasses 89 rules that are specifically designed to reflect contemporary standby practices.

These regulations address various aspects of standby letters of credit and demand guarantees, including issuance, transfer, assignment, scrutiny, and notification.<sup>87</sup> The primary objective of these regulations is to foster clarity and uniformity in the utilization of these financial instruments within the context of international trade financing. Presently, major banks that issue standby letters of credit are not only utilizing these rules, but are also advocating for their broader adoption. It is anticipated that ISP98 will emerge as the global standard in the forthcoming years. Furthermore, considering the significant connections between ISP98 and the Convention, along with UNCITRAL historical practice of endorsing similar frameworks, such as

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<sup>84</sup> U.N. Doc. A/CN.9/372, H 68-72.

<sup>85</sup> N 1 p 126

<sup>86</sup> United Nation Commission On International Trade Law, A/CN.9/477, (2000)

<sup>87</sup> *ibid*

UCP500 and Incoterms 1990, it is formally urged that the Commission consider endorsing ISP98.<sup>88</sup>

### **3.5.1 The Link between ISP98, Standby Letters of Credit, URDG, and the UN Convention**

Standby letters of credit serve as financial instruments primarily employed in construction and international trade to ensure that the contractor and the beneficiary meet contractual obligations. These instruments are guarantees issued by a bank on behalf of its client to ensure payment in the event that the client fails to satisfy their obligations under the agreement. To promote an efficient and secure process involving various forms of standby letters of credit, it is imperative for the parties engaged in these transactions to adhere to established rules such as ISP98, UCP 600, and URDG758.<sup>89</sup>

URDG 758, which has been developed by the ICC to provide a framework specifically for demand guarantees that are not governed by UCP600 or ISP98. Although there are overlaps between these three sets of rules, each possesses a distinct focus. ISP98 and URDG 758 are particularly tailored to address instances where the language of the guarantee is ambiguous. Ultimately, the selection of the applicable rule is contingent upon the preferences of the bank, the applicant, and the beneficiary.<sup>90</sup>

### **3.6 The Law of Demand Guarantees under the Ethiopian Legal System**

This analysis focuses on the search for relevant legislation and specific legal provisions that govern demand guarantees within the Ethiopian jurisdiction, traversing the realms of both private and commercial contract laws, specifically the Civil Code and the Commercial Code of Ethiopia. All legal actions are governed by pertinent general or specific laws that regulate the same types of transactions. A demand guarantee constitutes a contractual obligation designed to secure the

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<sup>88</sup> *ibid*

<sup>89</sup> Byrne, James E. *Standby & Demand Guarantee Practice: Understanding UCP600, ISP98 and URDG758*. Institute of International Banking Law & Practice, 2014

<sup>90</sup> Chhina, Ramandeep Kaur. *The ISP98 and The URDG758: A comparative Analysis Paper* presented at International conference on Trade, Business, Economics and Law. UK: Edinburgh, 2014

performance of the underlying relationship agreed upon by the parties involved. Therefore, such an obligation must align with at least one provision of domestic law to validate its applicability.

It is noteworthy that, due to the international character of demand guarantees, only a limited number of countries have enacted specific legislation addressing this instrument.<sup>91</sup> Given these contrasting circumstances, this paper will explore the legal framework surrounding demand guarantees in Ethiopian law, using two main variables for examination: the law itself and its practical application. Nevertheless, our discussion under this section is limited to the law. The practice will be addressed in the upcoming chapter, chapter four.

### **3.6.1 The Ethiopian Civil Code of 1960**

The term or an equivalent expression for a demand guarantee contract does not appear anywhere within the Civil Code of Ethiopia. Some scholars suggest that this type of transaction was not recognized during the codification period in the country, leading to the conclusion that a legal gap exists to accommodate demand guarantees within the existing framework.<sup>92</sup> Conversely, other scholars argue that law is inherently dynamic and can adapt to new economic or social phenomena. They posit that the provisions related to surety in the Civil Code are relevant and may be analogously applied to demand guarantees.<sup>93</sup> Thus, a comparative analysis of the legal nature of Suretyship and demand guarantees, particularly regarding the surety provisions of the Civil Code, is justified.

### **3.6.2 Independent vs. Accessory Nature of Suretyship**

The accessory nature of a surety bond implies its dependence on the principal contract. The obligations of the surety are conditioned by the underlying relationship, such that the obligation is not automatically triggered; the principal debtor's default is a prerequisite for the surety's obligation to come into effect.<sup>94</sup> Notably, under certain types of guarantees, such as simple guarantees, the surety may invoke Article 1942, which contrasts with the rules governing

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<sup>91</sup> R 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* 3 ed (2004) at 33–34;

<sup>92</sup> Gezu Ayele, *Ethiopian Banking and Commercial Instruments Law*, (Amharic) 2017 p 109-117

<sup>93</sup> In an interview with Ato Assefa, he invokes Art, 1942/1 of the Civil Code

<sup>94</sup> CC Art, 1920

demand guarantees. Specifically, Sub-article (1) of this provision explicitly states, “*the guarantor is entitled to raise all defenses available to the principal debtor against the creditor.*” These defenses may include the benefit of discussion, the benefit of division, and summons to proceed.

Still, proponents of the Civil Code have addressed the issue regarding demand guarantees and supported their positions using the same Article. They interpret the phrase “*...unless they are excluded by the nature of the guarantee*” as an implicit acknowledgment of demand guarantees, positing that the legislature at the time had anticipated a demand guarantee that was, however, not practicable both before and during the era of codification in Ethiopia. Nonetheless, the Civil Code introduced only two categories of guarantees, known as simple and joint guarantees, as stated in Article 1934. This provision stipulates that, except for the circumstances outlined in Article 1935 (joint guarantee), all guarantees are generally designated as simple guarantees. To assert that a joint guarantee resembles a demand guarantee and that it applies through analogy to a demand guarantee would violate the legal maxim, “*An exception is of the strictest application.*” Therefore, the concept of a demand guarantee lies outside the scope of the Civil Code.

### **3.6.3 The Limitations of Guarantee (Article 1924)**

In principle, “*A guarantee may not exceed the amount owed by the debtor, nor be contracted on more burdensome terms.*”<sup>95</sup> However, a demand guarantee contract typically involves conditions that may be more burdensome than those of an ordinary surety contract. Essentially, the magnitude of the guarantee is capped; this implies that the total debt owed by the debtor establishes the limit. This is particularly applicable in scenarios involving monetary debts. The creditor seeks to secure repayment of the entire debt by the guarantor in the event of the principal debtor's default. Conversely, in the case of bank guarantee bond, only a specific portion or percentage of the total debt is typically guaranteed. For instance, in construction contracts, it is customary for the guarantee amount to represent only 10% of the contract price.<sup>96</sup> Should the contractor fail to fulfill his obligations under the construction contract, the maximum liability of the guarantor is restricted to this 10% limit.

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<sup>95</sup> Ibid

<sup>96</sup> FIDIC, Condition of contract and public procurement directive No

#### **3.6.4 The Principal Obligation Void (Article 1923)**

The accessory nature of a surety contract indicates that, when the principal obligation is void, the guarantee contract is also rendered voidable. An exception to this rule is outlined in Article 1923(2) of the Civil Code of Ethiopia, which provides that a guarantee may remain valid if the guarantor was aware of the circumstances surrounding the principal obligation. Therefore, a contract that is not binding on the debtor due to reasons such as mistake or incapacity may still be validly guaranteed by the guarantor.

In the context of demand guarantees, however, the autonomy principle associated with guarantees alters this consideration. As previously noted, established fraud remains the only widely accepted exception to the autonomy principle of demand guarantees. Nonetheless, the question of whether a voidable contract affects a demand guarantee contract remains a contentious issue on the international stage. For example, within the English legal framework, neither the Court of Appeal nor the House of Lords has recognized the impact of illegality on the underlying obligation related to demand guarantees.<sup>97</sup> Conversely, the Convention has made attempts to address this matter in a limited manner. Under Article 19 of the UN Convention, a court's invalidation of the principal obligation may serve as an exception to the requirement of payment.

#### **3.6.5 The Defense for the Guarantor (Article 1926/2)**

In instances where a guarantor operates as a simple guarantor, the surety is entitled to utilize all defenses available to the principal debtor against the creditor.<sup>98</sup> Significantly, the waiver of these defenses by the principal debtor cannot be used to disadvantage the guarantor. This category of defenses is traditionally recognized as the traditional defense, characterized by their prevalence in court litigations.

The most notable defense, referred to as the benefit of discussion, is articulated in Article 1935 of the Civil Code. This provision allows the guarantor to require that the creditor discuss the principal debtor's assets and realize available securities before payment is demanded from the

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<sup>97</sup> N 1 p. 260

<sup>98</sup> Art, 1926/2 CC

guarantor.<sup>99</sup> This underscores the principle that the guarantor's liability arises only after the exhaustion of the principal debtor's properties. It is incumbent upon the guarantor to indicate the location of the principal debtor's available assets. However, a surety entering into a demand guarantee contract formally relinquishes this right and others, as mandated by the nature of the contract. Additional defenses, such as the benefit of division and summon to proceed, are also prevalent in regimes involving simple guarantees.

### **3.6.6 The Commercial Code of Ethiopia**

An analysis of demand guarantees within the Civil Code reveals the absence of explicit provisions regarding this instrument. As previously noted, international practices concerning demand guarantees are closely linked with documentary credit, particularly in the context of Stand-by Letters of Credit.<sup>100</sup> Within our jurisdiction, it appears impractical to consider demand guarantees outside the banking industry framework, as currently, no institutions other than banks provide such guarantees.

Book IV Title III Chapter V Sections IV Articles 959 to 967 of the old Commercial Code of Ethiopia addresses Documentary Credits, commonly known as Letters of Credit. These instruments are issued by banks that facilitate payments against the presentation of specified documents to the opening bank or its agent.<sup>101</sup> Such documents may include invoices, bills of lading, packing lists, and insurance policies covering transportation-related risks. The bank retains the authority to hold and manage the goods represented by these documents per the terms agreed upon with its principal. Banks play a crucial role in facilitating documentary credits to ensure smooth transactions in foreign trade. Importers requiring payment in foreign exchange to exporters must apply to a bank for the issuance of a Letter of Credit. The opening bank is then responsible for communicating with the correspondent bank to effect payment to the beneficiary.

Documentary credits share at least two key features with demand guarantees. The first is their independence from the underlying sales contract, which does not involve the bank as a party.<sup>102</sup>

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<sup>99</sup> Art,1934/2 CC

<sup>100</sup> Art,

<sup>101</sup> N 1

<sup>102</sup> Art, 959/2 the old Commercial Code

The second feature is the necessity for strict adherence to the instructions included in the Letter of Credit. Despite these similarities, the two instruments differ significantly in scope and purpose. A demand guarantee provides broader protection than a Letter of Credit. While a Letter of Credit offers protection solely against non-payment, a demand guarantee extends its coverage to non-performance, delayed performance, and even defective performance.<sup>103</sup>

### **3.7 Summary**

The evolution of bank demand guarantees is closely tied to documentary credits. Early nineteenth-century commercial practices significantly influenced the development of related laws. In an international context, legal frameworks for demand guarantees have advanced more substantially than in domestic contexts.

Many national legal systems lack explicit statutory provisions for demand guarantees, leading to disputes often being resolved through contractual provisions, unwritten rules, and case law. Efforts toward international harmonization have resulted in model laws, including the United Nations Convention on Independent Guarantees and Standby Letters of Credit, the Uniform Rules for Demand Guarantees (URDG) by the International Chamber of Commerce (ICC), and ISP98 (International Standby Practice).

The ICC has been drafting rules for documentary credits since 1933, with the Uniform Customs and Practice for Documentary Credits (UCP) addressing standby letters of credit since 1983. The URDG was published in 1992 specifically to address demand guarantees. The Uniform Rules for Contract Guarantees (URCG), published in 1978, provide guiding principles for guarantees in international trade. Article 9 requires substantiation of claims when calling on guarantees and distinguishes between simple on-demand guarantees and demand guarantees. URDG N 458 introduced rules for first-demand guarantees, emphasizing the independence of these guarantees from the underlying contract. URDG N 758, enacted in 2009, further clarifies this independence and introduces provisions for force majeure.

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<sup>103</sup> <https://www.investopedia.com/terms/d/demandguarantee.asp>

The UNCITRAL Convention on Independent Guarantees and Standby Letters of Credit, introduced in 1995, serves as a primary legal source for international demand guarantees and emphasizes the international nature of these undertakings. ISP98 provides a framework for standby letters of credit, aiming for clarity and uniformity in international trade financing and allowing parties to select applicable laws governing these instruments.

The chapter discusses the lack of explicit provisions for demand guarantees in the Ethiopian Civil Code and the Commercial Code. It highlights the dynamic nature of law and the potential for applying surety provisions to demand guarantees. The chapter concludes with an analysis of the limitations and characteristics of guarantees under Ethiopian law, emphasizing the distinctions between demand guarantees and traditional surety bonds.

## CHAPTER FOUR

### 4. DEMAND GUARANTEE IN CONSTRUCTION: THE LAW AND THE PRACTICE

#### 4.1 INTRODUCTION

This chapter examines the various types of construction guarantees and investigates the disputes associated with these guarantees. Additionally, the chapter primarily addresses the research questions concerning the governing law and judicial practices related to demand guarantees.

#### 4.2 The Phases of Construction Projects

Construction projects typically go through several phases, from initial conception to completion. A crucial first step in any project is conducting a feasibility study.<sup>104</sup> This analysis evaluates the practicality and potential success of the proposed project by assessing various factors, such as technical requirements, financial costs, legal considerations, and market demand. The primary goal is to determine whether the project is viable and worth pursuing.

Construction projects are generally categorized into three main phases: pre-construction, construction, and post-construction. In the case of road construction, the process is intricate and consists of several distinct phases, each encompassing specific tasks. Below are the typical phases involved:

- 1) Planning and Design; this involves conducting feasibility studies, performing environmental impact assessments, and developing detailed designs and engineering plans.
- 2) Land Acquisition and Permits; this process entails securing the necessary land, as well as obtaining the required permits and clearances.
- 3) Site Preparation; this phase includes clearing vegetation and debris, executing excavation and grading, and installing drainage systems.

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<sup>104</sup> Radosavljevic, M., & Bennett, J. (2012) Construction management strategies: A theory of construction management John Wiley & Sons

- 4) Sub-base and Base Construction; in this phase, the sub-base layer is laid down, and the base layer is compacted appropriately.
- 5) Paving this involves applying asphalt or concrete and finishing the surface effectively.
- 6) Finishing and Marking this includes installing curbs, sidewalks, and gutters, as well as painting road markings and placing signage.
- 7) Quality Control and Testing this phase focuses on inspecting the quality of construction, testing materials, and assessing structural integrity.
- 8) Maintenance and Repairs; this involves conducting regular inspections and addressing issues related to wear and tear.

### **4.3 Guarantees in Road Construction**

It is during the operational phase that the importance of guarantees in construction contracts comes to the forefront. Guarantees serve as essential financial instruments that significantly reduce risks and help ensure the sustainability of construction projects.<sup>105</sup> They are pivotal in securing financial commitments and enhancing overall contract performance, particularly through mechanisms such as advance payment guarantees, performance guarantees, and various other types.

The nature and specifics of these guarantees are fundamentally shaped by the contractual conditions governing each project. Renowned model contracts, like the FIDIC Conditions of Contract, commonly incorporate robust guarantee clauses. In the context of road construction, typical guarantees include advance payment guarantees, performance guarantees, and retention guarantees, which can be structured as either conditional or unconditional.

Importantly, the selection of a particular type of guarantee is influenced by the priorities of the parties involved and is also subject to regulatory constraints. For example, the National Bank of Ethiopia has placed restrictions on insurance companies, preventing them from issuing

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<sup>105</sup> Adetoyese Latilo, Ngozi Samuel Uzougbo, Munachi Chikodili Ugwu and Portia Oduro Role and effectiveness of advance payment guarantees in construction contracts World Journal of Advanced Science and Technology August 2024

unconditional guarantee bonds.<sup>106</sup> While many types of guarantees exist in construction contracts, this research focuses specifically on advance payment guarantees and performance guarantees.

#### **4.3.1 Advance Payment Bond in Construction**

In the realm of construction, the practice of advance payments to contractors has become a widely accepted norm, fostering financial stability and boosting project efficiency. An Advance Payment serves as a crucial contractual tool, typically allowing the contractors to receive a portion of the total project value - often around 20% - before commencing their obligations.<sup>107</sup> This advance is essentially a form of interest-free financing, enabling contractors to position themselves favorably for the project's demands. To secure this privilege, contractors are required to furnish an advance payment guarantee from a reputable bank or insurance company.

The guarantee document is multifaceted, encompassing several critical components that safeguard the interests of all parties involved. First, it delineates the coverage amount, which reflects the advance payment made by the employer and is a defined percentage of the total contract value.<sup>108</sup> Next, the guarantee articulates specific conditions under which the beneficiary can invoke the payment. Common scenarios that trigger such claims include contractor default, insolvency, or failure to achieve pivotal project milestones.

Furthermore, the guarantee specifies the validity period, outlining the duration for which the guarantee remains effective and thus available for claims. Included in this documentation is a detailed explanation of the claim process, which encompasses the necessary documentation and the required steps for notifying the issuing bank or insurance.<sup>109</sup>

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<sup>106</sup> NBE Directive no

<sup>107</sup> FIDIC

<sup>108</sup> Adetoyese Latilo, Ngozi Samuel Uzougbo, Munachi Chikodili Ugwu and Portia Oduro Role and effectiveness of advance payment guarantees in construction contracts World Journal of Advanced Science and Technology August 2024

<sup>109</sup> ibid

The contractor bears a critical responsibility to utilize the advance payment solely for project-related expenses. This funding is typically allocated for the procurement of essential plant and machinery and for mobilizing the workforce and equipment to the construction site. Additionally, contractors must adhere to a repayment structure outlined within the contract, ensuring that repayments occur in alignment with the agreed-upon terms. The construction contract often includes a mechanism for advance recovery, usually detailed in the Special Conditions, sometimes in the appendix to the Bid, and rarely in subsequent addendums.<sup>110</sup> Notably, once thirty percent of the total contract value has been certified in the Interim Payment Certificate, the contractor's obligation to repay the advance payment kicks in. Consequently, the employer reserves the right to withhold forty percent from the contractor's subsequent monthly payments until the advance payment is fully repaid. Given these stipulations, it becomes evident that contractors seldom escape the imperative to repay the advance payment.

The significance of an Advance Payment Guarantee bond cannot be overstated; it serves as a robust security measure in these transactions. Essentially, an Advance Payment Guarantee bond represents the guarantor's contractual commitment to the beneficiary, providing assurance for the repayment of the advance in the event of the contractor's default.

Typically, advance payment guarantees are issued in the form of unconditional guarantee bonds, a strategy designed to facilitate a smoother and more secure recovery process for the funds disbursed in advance by the employer.

#### **4.3.2 Performance Guarantee**

A performance bond is an essential financial instrument that ensures the fulfillment of a contract. It is the most common type of construction bond, in which every aspect of the contractor's performance is guaranteed.<sup>111</sup> This legally binding agreement involves one party, the obligator, making a formal commitment to another party, the obligee, to perform specific tasks or to abstain

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<sup>110</sup> Any of Road Construction Contract document

<sup>111</sup> John Murdoch and Will Hughes (2000), *Construction Contracts - Law and Management*, 3rd Edition, Spon Press, London (p 271)

from particular actions.<sup>112</sup> In the construction industry, it is common for contractors to be required to obtain a performance bond, which serves as a safeguard to guarantee both the quality and timely completion of their work. Typically, these bonds are structured as demand banker's guarantees, meaning they can be claimed by the beneficiary on demand without conditions.

In Ethiopia, employers generally require performance bonds valued at least 10% of the total contract price, offering a significant layer of protection and assurance for all parties involved.<sup>113</sup> In majority of cases, performance guarantees are presented in the form of conditional bond.<sup>114</sup> This does not mean that Banks are not willing to issue demand guarantee. In contrast, some banks prefer to issue unconditional performance bond.<sup>115</sup>

### **4.3.3 Types of Bonds in the Construction Industry**

In the construction sector, the prevalent bond is the conditional bond, wherein the surety agrees to disburse payment contingent upon the fulfillment of specified conditions.<sup>116</sup> In the context of a performance bond, the primary condition typically relates to any default or breach of contract by the contractor. For the employer to invoke payment it is necessary to provide substantiating evidence of the contractor's default and the consequent losses incurred.<sup>117</sup>

An alternative bond type is the unconditional or demand bond, which has been adopted in the construction arena from the international trade sector. This type of bond permits the beneficiary to solicit payment from the surety regardless of whether a default has occurred under the

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<sup>112</sup> Awang Ihsan, AwangYunus1 and Khairul Anuar Maarof 1-2Faculty of Architecture, Planning and Surveying, Universiti Teknologi Mara, Sarawak, Malaysia awangihsan@sarawak.uitm.edu.my

<sup>113</sup> Art, 16. 25. 2 of procurement directive 2010

<sup>114</sup> During an interview with Ato Assefa, the Team Leader of the Court Affairs Follow-Up Team within the Legal Directorate at Addis Ababa City Roads Authority (ACRA), he stated that ACRA almost always accepts conditional performance guarantees.

<sup>115</sup> In another interview with Ato Solomon Belete, Legal Director at *Hibret Bank S.C.*, he argued that a demand guarantee is more beneficial for the employer than for the guarantor. The employers can easily enforce their financial interests outlined in the guarantee bond, with little to no dispute.

<sup>116</sup> John Murdoch and Will Hughes (2000), *Construction Contracts - Law and Management*, 3rd Edition, Spon Press, London

<sup>117</sup> Ibid

principal contract, provided that the request is not fraudulent. In this scenario, the surety is obligated to make payment unless there is unequivocal evidence of such fraud.<sup>118</sup>

#### **4.4 Disputes in Road Construction**

Construction projects are crucial for a nation's infrastructure and economic growth, creating jobs and generating wealth. However, their large scale and financial commitments introduce inherent risks, often leading to complex disputes. These conflicts arise from various factors, including project size, multiple contracting parties, poorly drafted contracts, inadequate planning, financial issues, and communication barriers.

The construction industry is highly susceptible to contract claims, occurring among owners, contractors, subcontractors, and suppliers. Disputes stem from conflicts over shared resources and differing priorities and beliefs.<sup>119</sup> While uncomfortable and costly, these disputes are an unavoidable aspect of construction contracts.<sup>120</sup>

In Ethiopia, rapid economic growth has triggered significant construction activity. The government, as both client and contractor, is responsible for vital infrastructure projects, including health facilities, educational institutions, and extensive public works like roads and power generation.

With the need for improved transportation infrastructure, the road sector expects substantial investments. However, road construction is fraught with risks, particularly conflicts that can lead to delays, cost overruns, and quality issues. Understanding the root causes of disputes is essential for completing projects on time and within budget.<sup>121</sup>

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<sup>118</sup> Ibid

<sup>119</sup> Leung, M., Ng, S. T., and Cheung, S. O. (2002). Improving satisfaction through conflict stimulation and resolution in value management in construction projects. *J. Manage. Eng.*2(68), 68–75

<sup>120</sup> John Murdoch and Will Hughes (2000), *Construction Contracts - Law and Management*, 3rd Edition, Spon Press, London

<sup>121</sup> Assegid Getahun, Yolente C. Macarubbo,: *Assessment of Construction Dispute Alemu Mosisa* (sep 12,2016) *Resolution in Ethiopian Somali Regional State Road Projects: A Case Study on Road Projects in the Somali Region*

#### **4.4.1 Types of Disputes in Road Construction**

Surveys have identified several key sources of conflict within construction projects:<sup>122</sup>

- 1) Owner-Related Issues; The inherent complexities of construction frequently lead to unavoidable errors that can escalate into disputes, particularly as a result of delayed payments.
- 2) Contractor-Related Factors; the competence of a contractor plays a critical role in project success. Effective management practices can mitigate the likelihood of disputes, whereas ineffective management significantly heightens the risk of conflicts.
- 3) Consultant-Related Disputes; A majority of conflicts involving consultants stem from challenges such as design modifications and insufficient project requirements, which can result in project delays and subsequent disagreements.
- 4) Third-Party and Human Behavior Issues; While certain factors, such as team dynamics, can be managed effectively, external influences—such as natural disasters—are beyond control and may prompt conflicts.
- 5) Design and Contract-Related Disputes; Ambiguous language in contracts can lead to misunderstandings, while a lack of clarity in design consistently contributes to disputes throughout the project lifecycle.

Disputes within the construction industry are typically categorized as conflicts between employers and contractors. These disputes can result in substantial project delays, with some research indicating slowdowns of up to 460% in specific cases.<sup>123</sup>

#### **4.4.2 Settlement of Disputes in Road Construction**

The construction industry presents a complex and competitive landscape characterized by the involvement of individuals possessing diverse perspectives, talents, and levels of expertise. In

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<sup>122</sup> Sagar Soni, Mukesh Pandey, Sohit Agrawal. Conflicts and Disputes in Construction Projects: An Overview:

<sup>123</sup> Abebe Dinku & Girmay Kahsay. (2003). Claims in international Construction projects in Ethiopia and case study on selected sites, journal of EEA, Vol 20, Addis Ababa.

this intricate environment, professionals from various disciplines, each with distinct ambitions, seek to optimize their benefits.<sup>124</sup>

Conflicts are an inevitable consequence of varying perceptions among project participants. If such confrontations are not managed appropriately, they can swiftly escalate into disputes, which constitute a principal barrier to the successful completion of construction projects. Therefore, it is imperative to understand the fundamental causes of disputes to ensure that construction projects are completed on time, within budget, and to the expected quality standards.<sup>125</sup>

Construction claims are prevalent in nearly every construction project. Stakeholders typically seek timely completion, adherence to budgetary constraints, and high-quality outcomes. However, the construction process is frequently fraught with disagreements related to the interpretation of construction documents, existing conditions, the legality of modifications, timely payments, and related matters. Consequently, disputes are an inherent aspect of the construction industry, particularly in road construction.<sup>126</sup>

This study emphasizes the settlement of guarantee-related disputes. When disputes surface within legal contexts, they should be approached constructively and collaboratively in order to facilitate early and effective resolutions.

Traditional methods, such as arbitration and litigation, are available for resolving these issues; however, these should be considered only as a last resort. Alternative Dispute Resolution (ADR) has been proposed as a preferred route to address criticisms related to cost, time consumption, and contentiousness.<sup>127</sup>

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<sup>124</sup> Marzooq Abdul Karim, 'The Dispute in the Construction Industry in the Kingdom of Bahrain' (MSc thesis, University of Sanford-Manchester, 2015)

<sup>125</sup> Ibid

<sup>126</sup> (Marzooq, 2015)

<sup>127</sup> Chaitanya Khekale and Nityan and Futane, 'Management of Claims and Disputes in Construction Industry' (2015) 4(5) International Journal of Science and Research (IJSR) 853.

#### 4.4.2.1 Amicable/Alternative/Appropriate Dispute Settlement Mechanisms

**Negotiation:** - Negotiation entails a process of reaching an agreement through direct communication without the involvement of a third party.<sup>128</sup> It is typically the initial and concluding step necessary for addressing disputes within the road construction sector.<sup>129</sup> This process is voluntary and unstructured, relying on mutual agreement by both parties and conducted in a confidential environment. Moreover, negotiation can be utilized to resolve disputes throughout the project lifecycle, even when other resolution mechanisms are in operation. Despite its acknowledged merits, negotiation is not always successful. Its strengths lie in confidentiality, privacy, flexibility, and the low costs associated with airing settlement terms. However, its consensual nature poses both strength and a limitation.

**Mediation/Conciliation:** - Mediation is a dispute resolution method involving a third-party impartial mediator. In this context, the disputing parties retain the decision-making process and resultant outcomes. The mediator's role is to facilitate an environment for dialogue and ensure that both parties articulate their positions, consider genuine needs, and comprehend each other's viewpoints, as well as focus on the critical issues at hand. Notwithstanding its advantages, mediation has been criticized for its reliance on the willingness of parties to engage, its lack of coercive power, and challenges in enforcing outcomes.<sup>130</sup>

**Expert Determination:** - In this method, parties execute a contract stipulating that a third party will render a binding decision regarding their dispute. The terms governing this process are established in advance. This is also common in road construction contracts.

**Dispute Adjudication Board:** - Adjudication was introduced in the United Kingdom in 1998 and has since gained widespread acceptance. Depending on the contractual agreement, when the adjudication act is incorporated into the contract documents, either party may request the appointment of an adjudicator within one week of delivering a notice of dispute. The adjudicator

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<sup>128</sup> *ibid*

<sup>129</sup> (Marzooq, 2015)

<sup>130</sup> (Marzooq, 2015)

is required to issue a binding decision regarding the dispute to the parties within a four-week timeframe.

#### 4.4.2.2 Judgmental/Binding Dispute Resolution Systems

**Arbitration:** - In the context of road construction projects, arbitration is arguably the most widely utilized method for resolving technical disputes. This process is quasi-judicial in nature, adhering largely to legal protocols, making it essential that the arbitrator or panel of arbitrators possesses a thorough understanding of legal procedures. Although the arbitration process may differ in scope based on legislative intent, it is universally available within the legal systems of all nations.<sup>131</sup> While parties retain the freedom to select the number of arbitrators, it is imperative that this number remains odd to prevent any possibility of a tie in the award. Similar to traditional judicial processes, technical disputes may be resolved by a single arbitrator or a panel constituted of multiple arbitrators. Typically, the contractor and the owner nominate one arbitrator each, and together they select a third arbitrator to complete the panel.

**Litigation:** - Resolving disputes through the legal system offers numerous ancillary advantages; most notably, court rulings over time have established a stable legal foundation that can be utilized for contract drafting and dispute resolution across various forums. It is generally recognized that the involvement of courts in construction law matters should be maintained, complementing rather than replacing alternative dispute resolution (ADR) mechanisms.<sup>132</sup> Construction litigation is often characterized by its considerable costs, time demands, and complexity. Despite these drawbacks, the establishment of specialized courts offers three primary benefits. First, it enhances decision-making quality by engaging experts to adjudicate complex cases. Second, it alleviates case backlogs in generalist courts by transferring specific categories of complex factual and legal cases to specialized courts more equipped to handle them, resulting in fewer appeals. Third, it diminishes the number of judicial hours necessary to

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<sup>131</sup> Shaikh Sk. Sameer, Dr. Rajendra B. Magar, Fauwaz Parkar, 'Claims and Disputes in Construction Projects' (2016) 4(11) International Journal for Research in Applied Science & Engineering Technology (IJRASET).

<sup>132</sup> Beverley McLachlan, 'Judging the 'vanishing trial' '(2010) 5(2) Construction Law International (CLI) 13. Markus B. Zimmer, "Overview of Specialized Courts" [2009] International Journal for Court Administration (IJCA)

process intricate cases by utilizing legal and subject-matter experts for adjudication.<sup>133</sup> The creation of specialized courts marks a significant development in the road construction industry, as the establishment of construction courts will fundamentally transform the landscape by facilitating expedited reviews of construction-related disputes more rapidly than traditional courts.<sup>134</sup>

#### **4.5 Construction Guarantee Disputes**

This paper primarily examines disputes stemming from Construction Guarantees. A significant number of disputes in construction arise between employers and contractors; however, when focusing on construction guarantee disputes, the principal parties involved are usually the employer and the guarantor. This issue is particularly pertinent in the context of demand guarantee bonds. In Ethiopia, demand guarantees have emerged as a major source of conflict within the road construction sector.<sup>135</sup> Numerous cases involving demand guarantees ultimately advance to court due to the reluctance of issuing banks to make payments upon first demand by beneficiaries.<sup>136</sup> The research questions addressed in this paper will concentrate on these issues.

##### **4.5.1 Settlement of Guarantee Disputes in Road Construction**

A letter of guarantee, whether conditional or unconditional, is issued in alignment with the underlying relationship. The underlying relation can be either contractual or extra-contractual, though it typically pertains to contracts. Relatively, the guarantor's obligations are always derived from a contract. Essentially, a letter of guarantee is a contract in which banks are committed to the beneficiary in the event of default by the principal.

In Ethiopia, these letters of Guarantees are categorized as personal guarantees or Suretyship guarantees and are governed by Article 1920 and subsequent sections of the Civil Code,

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<sup>133</sup> Markus B. Zimmer, 2009 *Overview of Specialized Courts*. International Journal for Court Administration, Vol. 2, No. 1, 2009.

<sup>134</sup> The Federal High Court Lideta Division Construction Bench

<sup>135</sup> In an Interview with Ato Assefa

<sup>136</sup> Ibid

according to the interpretation of the Court of Cassation.<sup>137</sup> However, it is important to note that these provisions do not apply to unconditional guarantees.<sup>138</sup>

Some experts argue that the Suretyship provisions of the Civil Code, which address personal guarantees requiring individual commitments, do not adequately correspond to conditional bank guarantees. Therefore, they recommend the establishment of new legislation specifically governing conditional guarantees.<sup>139</sup> On the other hand, some argue that the Civil Code is adequate to govern this transaction.<sup>140</sup> Whether it is a documentary guarantee or a personal guarantee, both types share fundamental characteristics. They are accessory obligations, meaning the guarantor's obligation relies on the default of the principal debtor. This arrangement is a tripartite agreement involving three parties: the principal debtor, the guarantor, and the creditor. Suretyship is a type of contract where one party (the surety) agrees to take responsibility for another party's (the principal debtor's) obligations. Typically, the surety does not expect any consideration or payment from the principal debtor. This is evident from Article 1921, which states that a surety can be established with or without the knowledge or consent of the principal debtor. However, the surety and the principal debtor are free to agree on providing some form of consideration if they wish.<sup>141</sup> Therefore, in the case of conditional Letter of Guarantee we have a legal regime that accommodates the transaction. Any disputes arising from this transaction can be properly adjudicated accordingly. The primary focus of this paper is the unconditional guarantee, and we aim to identify the laws governing this transaction in the following discussions.

#### **4.6 What is the Law that Governs Demand Guarantee in Ethiopia?**

As we discussed in Chapter three of this paper, effort has been done to explore presence of demand guarantee in the Civil Code and the Commercial Code of Ethiopia. Although we found no clear word or equivalent concept in these codes, unconditional guarantee is still practicable.

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<sup>137</sup>Cassation File No. 168954 and 47004

<sup>138</sup> Id

<sup>139</sup>Gezu Ayele, Ethiopian Banking and Commercial Instruments Law, 2017 p 109-117

<sup>140</sup> In an interview with Ato Solomon Belete, Legal Directorate Director at *Hibret* Bank S.C. conducted in February 21, 2025

<sup>141</sup> Tilahun Teshome The Basic Principles of Ethiopian Contract Law Addis Ababa 1997 p 261

Demand guarantee is actually a type of documentary guarantee and the object of the transaction is the document itself.<sup>142</sup> In Ethiopia, there is currently no comprehensive legislation governing demand guarantees.<sup>143</sup> However, the lack of explicit legal frameworks does not inherently invalidate such transactions. A demand guarantee constitutes a contractual arrangement between the guarantor and the beneficiary and can be understood as a specific type of contract.<sup>144</sup> In practice, the guarantee contract is often documented through a simple instrument signed solely by the guarantor. This has led to a degree of controversy among professionals regarding its status as a formal contract, particularly due to the absence of signatures from both parties and witnesses, among other critical elements.<sup>145</sup> Consequently, it is not feasible to manage this intricate transaction solely with a one or two pages letter of guarantee. This is reflected in the significant gaps and limitations present in the documentation.<sup>146</sup>

In light of this situation, the general provisions of contract law may be employed to govern demand guarantees. General contract law serves a dual purpose in this context: it addresses gaps in scenarios where there is no special contract governing a specific transaction, and it provides clarity when a special contract exists but fails to adequately address certain issues. Thus, the relevance of new legislation governing demand guarantees can be assessed from two perspectives.<sup>147</sup> First, general contract law may not adequately address the specific concerns associated with demand guarantees. Second, the establishment of new legislation is crucial due to the unique characteristics of demand guarantees. Additionally, the practices observed in international business transactions reinforce this necessity, as evidenced by the URDG and the UN Convention on Independent Guarantees, which respond to private international law challenges in this area.<sup>148</sup>

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<sup>142</sup> Dinh Xuan Trinh *Demand Guarantee Is Actually A Type Of Documentary Guarantee*, international Journal of Economics, Commerce, and management United Kingdom Vol. 11, Issue 2, Feb 2023

<sup>143</sup> In an interview with Ato Solomon Belete,

<sup>144</sup> In an interview with Ato Wubetu Assefa, Legal Directorate Director at Bunna Bank SC conducted in February 25, 2025

<sup>145</sup> Gezu Ayalew p 112

<sup>146</sup> Ato Wubetu Assefa

<sup>147</sup> Ibid

<sup>148</sup> N 53

#### **4.7 What could be the Possible Consequences for the Parties engaged in a Demand Guarantee in the Absence of Comprehensive Legislation?**

The practices of banks issuing Demand Guarantees lack uniformity in terms and conditions. Many of the wording, expressions, and conditions used in guarantee documents can be confusing. Furthermore, these documents often borrow concepts from international instruments like the URDG and ISP98 without directly referencing them. This can lead to complications during dispute settlement proceedings related to guarantees.<sup>149</sup>

Courts typically interpret guarantee documents by relating them to a relevant area of domestic law. Their approach involves reading the document as a whole, taking into account its clauses, surrounding circumstances, and the intentions of the parties involved.<sup>150</sup> Therefore, in the absence of comprehensive domestic legislation governing demand guarantees, parties are encouraged to refer to international instruments such as the URDG, or ISP98. However, establishing a legislative framework for demand guarantees would be a highly advisable solution.<sup>151</sup> These international instruments should guide any development of local legislation in this respect.

##### **4.7.1 If Legislation is Deemed Necessary, What Kind of Legislation Should it be?**

Legal transplantation has long been practiced across different legal systems around the world.<sup>152</sup> This phenomenon occurs for several reasons: (i) authority, (ii) prestige and imposition, (iii) chance and necessity, (iv) the expected efficacy of the law, and (v) political, economic, and reputational incentives from various countries and third parties.<sup>153</sup> Thanks to the international legal framework, there are promising initiatives aimed at unifying and harmonizing domestic

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<sup>149</sup>N 54 Ato Solomon

<sup>150</sup>Charl Hugo, Demand Guarantees In The People's Republic Of China And The Republic Of South Africa, BRICS Laow Journal Volume Vi (2019) Issue 2

<sup>151</sup> All interviewees agreed on this point

<sup>152</sup>WATSON, ALAN. Legal transplants and European Private Law, Ius Commune Lectures on European Private Law, 2 (electronic version). Dutch Institute of Comparative Law.

<sup>153</sup>International Law Legal Transplants And Comparative Law Irma Johanna Mosquera Valderrama p 3 Electronic copy available at: <http://ssrn.com/abstract=2017940> 2611)

legislation with international law standards.<sup>154</sup> In this regard, we have two sources for legal borrowing: Conventions and Uniform Rules or self-regulations, the latter of which includes the Uniform Rules for Demand Guarantees (URDG) and ISP98.

Conventions serve as a means of unifying and harmonizing of laws. The UN Convention on Independent Guarantees and Stand-by Letters of Credit is currently the primary vehicle for achieving global unification of domestic legislation.<sup>155</sup> Although the General Assembly adopted the Convention on December 11, 1995, it has only been ratified by eight states and came into force on January 1, 2000.<sup>156</sup> The ratification process took about five years among the signatory parties, indicating a low level of international interest in the Convention.<sup>157</sup> Instead, countries have opted to incorporate the convention rules into their domestic laws through Codes or special statutes.<sup>158</sup>

The Convention has both merits and drawbacks identified in practice:

- The Convention includes mandatory provisions that are essential for preventing fraud, leading to significant unifying results.
- It complements existing self-regulatory frameworks found in URDG, UCP, and ISP98, allowing market participants to choose among five types of instruments or a combination of them.

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<sup>154</sup>the history of the work done by UNCITRAL in the process of harmonization of international commercial law began in 1966 AN INTERNATIONAL LEGAL REGIME FOR RECEIVABLES FINANCING: UNCITRAL'S CONTRIBUTION", page 315, BAZINAS, DUKE JOURNAL OF COMPARATIVE & INTERNATIONAL LAW, 12/16/1998.)

<sup>155</sup>Legal Harmonization Through Model Laws: The Experience Of The United Nations Commission On International Trade Law (UNCITRAL) Page 10, José Angelo Estrella Faria, [Http://Www.Justice.Gov.Za/Alraesa/Conferences/2005sa/Papers/S5\\_Faria2.Pdf](http://Www.Justice.Gov.Za/Alraesa/Conferences/2005sa/Papers/S5_Faria2.Pdf)

<sup>156</sup>Belarus, Ecuador, El Salvador, Gabon, Kuwait, Liberia, Panama, and Tunisia, The USA is a signatory yet not ratified.

<sup>157</sup>The Duality of the "U.N. Convention on Independent Guarantees and Stand-by Letters of Credit" and the main reasons for its non-functionality Dr. Davit Atabegashvili)

<sup>158</sup>Lx Filip De, The UN Convention on Independent Guarantees and Stand-by Letters of Credit, 33 INT'L L. 831 (1999) <https://scholar.smu.edu/til/vol33/iss3/16>)

- Article 13 of the Convention does not address *extend or pay* issue as Article 26 of URDG does.
- The Convention lacks sufficiently detailed rules regarding counter-guarantees or the confirmation of standby letters of credit.
- It does not provide strong protection for the account party against fraud.

The UN Convention on Independent Guarantees and Stand-by Letters of Credit addresses both independent guarantees and standby letters of credit within a single legal regime.<sup>159</sup> Functionally, a Standby Letter of Credit is recognized as an equivalent demand security to bank guarantees under the Convention, distinguishing it from the category of Documentary Letters of Credit. A Standby Letter of Credit aims to protect the interests of the beneficiary and establish a favorable market position, whereas a Documentary Letter of Credit primarily safeguards the interests of the principal.<sup>160</sup>

The main distinction between a Bank Guarantee and a Standby Letter of Credit, as opposed to a Documentary Letter of Credit, lies in their unconditional enforceability and independence from any underlying obligation.<sup>161</sup> This principle of independence is a key distinguishing feature. Additionally, a Documentary Letter of Credit involves four distinct types of legal relationships, in contrast to the three types associated with a Bank Guarantee.<sup>162</sup>

Despite sharing numerous characteristics, Independent Guarantees and Stand-by Letters of Credit are not identical.<sup>163</sup> Only the autonomy and independence of the guarantee obligation unify these two financial instruments within international commercial law. Therefore, when the legislative adaptation process is restricted to independent guarantee law, care must be taken not to confuse the unique features of each instrument.

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<sup>159</sup>Charl Hugo, Demand Guarantees)

<sup>160</sup>The Duality of the “U.N. Convention

<sup>161</sup>The Duality of the “U.N. Convention)

<sup>162</sup>ibid

<sup>163</sup>During the 18th Session of the Working Group, the United States Delegation proposed regulating Independent Guarantees and Standby Letters as separate but equal components of the Convention.

## 4.8 Basic Features of Demand Guarantee

In the context of guarantees, the initial critical step is to ascertain whether the guarantee is independent or accessory in nature. There exists notable variation among jurisdictions regarding this classification. Certain jurisdictions, such as South Africa, which relies on case law,<sup>164</sup> impose a requirement to interpret the guarantee document holistically to discern the parties' intentions. In contrast, jurisdictions such as China adopt a more rule-based framework, wherein a guarantee is deemed independent if it incorporates the URDG or other applicable independent guarantee regulations, or if the guarantee explicitly states that it is payable on demand with minimal scrutiny of the documents.<sup>165</sup> It is important to note that these criteria are not present in the case laws of South Africa.

When dealing with an independent guarantee, the principal inquiry pertains to the extent of that independence. This includes consideration of whether the legal framework permits exceptions to this independence. Notably, instances of fraud and abuse of rights perpetrated by the beneficiary may constitute exceptions to the principle of independence. However, it is crucial to recognize that third-party fraud cannot impede an innocent beneficiary's entitlement to payment. Moreover, fraud involving the documents presented by the beneficiary, which the beneficiary is aware of, is seldom observed in guarantees, as demand guarantees are less reliant on documentation than standby letters of credit. Some commentators argue that these exceptions may lead to potential abuses of the beneficiary's rights. Conversely, others maintain that the concepts of 'fraud' and 'abuse of rights' are well-established in various national legal systems, thereby mitigating the risk of 'abusing rights' by beneficiaries.<sup>166</sup> This topic has been the subject of debate within the UNICITRAL Working Group.<sup>167</sup> The convention endeavored to address these concerns by

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<sup>164</sup>(South Africa, with its complex colonial history involving roots in the Netherlands and France, followed by British occupation, is generally regarded as a mixed jurisdiction. Unlike the continental legal systems, but like the English common law, Roman-Dutch law in South Africa has never been codified)

<sup>165</sup>. (The New Chinese Independent Guarantee Rules & Legal Issues in Trade with China Vincent O'Brien 20 November 2018 Art, 20 it was released in a meeting of the Judicial Committee of the Supreme People's Court on 7 July 2016 and came into effect on 1 December 2016)

<sup>166</sup>(Charl Hugo, Demand Guarantees In The People's Republic Of China And The Republic Of South Africa, BRICS Law Journal Volume VI(2019) Issue 2)

<sup>167</sup> (Debates between the UNICITRAL Working group)

instituting standards that seek to balance the interests of both the guarantor and the beneficiary. The principles of good faith and reasonable care ought to be adhered to by each party while exercising their rights and fulfilling their obligations under the guarantee.<sup>168</sup>

In South Africa, the fraud exception to the independence principle was explicitly recognized for the first time in the notable letter of credit case.<sup>169</sup> In China, the application of the fraud exception, and the consequent termination of the guarantor's payment obligations under the independent guarantee, requires the court to establish beyond a reasonable doubt the existence of fraud within the independent guarantee.<sup>170</sup> Additionally, in cases concerning the choice of law, the substantive law of the jurisdiction of the independent guarantee issuer governs disputes related to foreign-related independent guarantee fraud.<sup>171</sup>

In the context of an independent guarantee, only the principal or instructing party possesses the right to seek a provisional measure against the payment of a demand guarantee in a court of law. The Convention establishes the standard of proof required to obtain such a provisional measure.<sup>172</sup> Therefore, the instructing party must present compelling evidence that demonstrates the existence of fraud or abuse of rights by the beneficiary, effectively convincing the court beyond a reasonable doubt. The effect of provisional measures is to block payment or freeze the proceeds of the guarantee. It is important to note that the Convention recognizes only provisional court measures and is silent on the matter of conservatory measures.<sup>173</sup>

The criteria for determining whether a call on the guarantee is abusive or fraudulent are delineated in Articles 19 and 20 of the Convention. Under an independent guarantee, payment is a principle that is an exception only in instances of fraud, particularly when the bank is not obligated to make payment. According to the Convention, fraud is defined as the condition in which any document is either not genuine or has been falsified, no payment is due based on the

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<sup>168</sup>the duality of UN Convention

<sup>169</sup>\*Phillips v. Standard Bank of South Africa Ltd\*.

<sup>170</sup>(The New Chinese Independent Guarantee Rules)

<sup>171</sup>Art, 22.2 ICG

<sup>172</sup>Article 20.1

<sup>173</sup> Id n 167

assertions made in the demand and supporting documents, or, based on the nature and purpose of the undertaking, the demand lacks any conceivable basis.<sup>174</sup>

When considering whether the ongoing lawsuit or arbitration between the instructing party and the beneficiary is a valid reason to withhold payment on the guarantee, it is important to note that the guarantor is only relieved of the obligation to pay if a court or arbitral tribunal has declared the principal's underlying obligation is invalid. This is unless the guarantee specifically states that such situations are included in the risks covered by the undertaking. According to Article 19.2(b), only the decision rendered by a court or arbitration that invalidates the underlying obligation of the principal provides the grounds to block payment under the guarantee. Consequently, no provisional measure is supported by the Convention until the dispute between the principal and the beneficiary is resolved in a manner that renders the underlying obligation of the principal invalid.

#### **4.9 Review of Selected Court Decisions**

In the preceding discussions, I have highlighted that our legal system lacks clear and comprehensive legislation governing unconditional guarantees. This raises the question of how Ethiopian courts have handled cases involving demand guarantees and the outcomes of these cases. In this section, we will focus on the judicial practices surrounding such cases. I have reviewed unpublished court cases related to demand guarantees, primarily in the construction sector. However, the writer has found no arbitral awards pertaining to unconditional guarantee cases.

##### **4.9.1 Case One**

This text reviews the court decision associated with File No. 276444, adjudicated by the Federal High Court (FHC) Lideta Division 1st Construction Bench on 22/02/2015 EC. The dispute arose between the Ethiopian Roads Authority/Employer v Abay Bank SC/guarantor.

The core issue involved an unconditional advance payment bank guarantee bond issued to the employer on behalf of the contractor in relation to a road construction project. Following the

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<sup>174</sup> Art, 19 of the UN Convention

acceptance of the guarantee bond, the employer disbursed an advance payment totaling ETB 176,823,008.00 to the contractor. Subsequently, the contract was terminated due to alleged defaults attributable to the contractor. In response, the employer requested payment of the bond value from the guarantor. The guarantor did not formally accept or reject this request, opting instead to remain silent. Consequently, the employer initiated legal proceedings in the FHC Lideta Division 1st Construction Bench.

In his submissions, the employer contended that the guarantee should be honored upon demand, without any objections and independently of the underlying contract. Conversely, the guarantor disputed the employer's claim, asserting that the nature of the guarantee rendered it conditional, as it was allegedly issued to support the main contract. The guarantor referenced Cassation decisions from the Federal Supreme Court of Ethiopia to bolster this argument, leading to extensive discussions concerning the contents of the construction contract during both written submissions and oral arguments.

#### ➤ **Court Decision and Reasoning**

The court ultimately validated the unconditional nature of the guarantee, ruling in favor of the employer. The court's rationale was grounded in the explicit terms of the Letter of Guarantee and referenced Cassation Decision File No. 168954. A crucial aspect of the court's determination was the principle that an unconditional guarantee operates independently of the underlying contract. Consequently, the court dismissed all defenses presented by the guarantor that were associated with the construction contract. The court even drew parallels between the guarantee and a *cheque*, further solidifying its position.

#### ➤ **Comments**

- 1) In the normal course of litigation, the burden of proof lies with the plaintiff. In this case, the plaintiff's arguments primarily reference the underlying contract. However, this approach contradicts the independent nature of the guarantee. By doing so, it allows the defendant to mount an appropriate defense. Importantly, the independent nature of the guarantee relieves the plaintiff of the burden of proof regarding the underlying contract.

- 2) The court has drawn a compelling comparison between unconditional guarantees and *cheques*. Although they share certain similarities, they are fundamentally distinct in nature. An unconditional guarantee is a robust mechanism designed to secure obligations within a commercial contract, while a *cheque* merely functions as a tool for payment. This distinction underscores the critical role that unconditional guarantees play in fostering trust and accountability in business transactions.
- 3) During the proceedings, the court opted not to hear witness testimony, choosing instead to focus exclusively on the Letter of Guarantee. In my view, this decision was prudent, as the nature of the guarantee and the obligations of the guarantor could not be effectively articulated through witness accounts.

#### **4.9.2 Case Two**

File No. 276341, decided on 25/02/2015 by the FHC Lideta Civil Division 1st Construction Bench, involves the same parties as Case 1. The only differences are the amount of money involved in the guarantee and the file number of this case. Other than that, it closely mirrors the first case. The written submissions, oral arguments, and evidence presented are quite similar. Even the court's decision and reasoning appear to be copied from the previous case. Consequently, I will not summarize this case, as it does not add significant new information. However, there is one important issue worth addressing.

In his statement of claim, the plaintiff/employer notes that the contractor has achieved 32% performance. The defendant/guarantor contends that if the contractor has reached this level of performance, the advance payment should be adjusted accordingly based on the amount of work completed. The plaintiff responded by asserting that the repayment mechanism for the advance payment involves a 30% deduction from the Interim Payment Certificates (IPC), which will begin once 30% of the contract value has been paid to the contractor.

However, the plaintiff displayed inconsistency between his written submission and oral presentation. In his written submission, he stated that the contractor has already reached a performance level of 32%. Yet, during his oral presentation, he claimed that the contractor could not repay the advance because he had not achieved a 30% performance level. Despite these

discrepancies, the court did not address the issue and simply rejected the claim, reasoning that the defendant failed to prove that the contractor would commence repaying the advance money.

➤ **Court Decision and Reasoning**

In a similar manner to the previous case, the court based its judgment on the nature of the guarantee and the cassation decision. This unpublished cassation decision File No. 168954 introduced a new legal norm concerning demand guarantees in Ethiopia's legal system. According to this ruling, unconditional guarantees are subject to the Uniform Rules for Demand Guarantees (URDG). This rule includes an exception for cases of fraud by the beneficiary, which allows for the denial of payment on the bond.

➤ **Comment**

- In my opinion, the plaintiff's inconsistent argument regarding the repayment of the advance money amounts to fraud. Given that 32% of the contract value has already been paid to the contractor, the plaintiff should have started deducting the guarantee amount from the monthly payments. However, the plaintiff failed to do this and claimed that the demand for the full amount of the guarantee was unfair and contrary to good faith. Additionally, Article 25 states that the amount payable under the guarantee shall be reduced by any payments made under that guarantee.

### **4.9.3 Case Three**

Cassation decision File No. 168954 decided at 25 *Tikimt* 2012 EC. The case involved Trade Path International PLC (Applicant/Instructing Party), Turkish Airlines (Beneficiary), and Zemen Bank SC (Guarantor) Respondents. Initially adjudicated in the Federal High Court, the Applicant was the plaintiff, while the first and second Respondents served as defendants.

The primary issue centered on an unconditional performance bond bank guarantee issued by Zemen Bank on behalf of the Applicant to Turkish Airlines related to an air cargo sale commission agency contract. The Beneficiary sought payment from the Guarantor, alleging that the Applicant had defaulted. Despite objections from the Instructing Party, the Guarantor paid the amount.

The matter was then escalated to the Federal High Court, which ruled in favor of the Respondents, stating that the guarantee was unconditional and independent of the underlying contract. Both the Federal Supreme Court Appellate Division and the Cassation bench, demonstrating consistent judicial treatment of unconditional guarantees, upheld this decision.

#### **4.10 Summary**

This chapter delves into the intricate world of construction guarantees, illuminating the various types that exist and the disputes that often arise in their context. The narrative addresses critical research questions surrounding the governing laws and judicial practices that pertain to demand guarantees, shedding light on their complexities and implications.

Construction projects unfold in a structured manner, typically divided into three significant phases: pre-construction, construction, and post-construction. Each of these phases encompasses a series of specific tasks that are vital to the overall success of a project.

In the realm of road construction, guarantees serve as crucial financial instruments that not only mitigate risks but also foster project sustainability. Among the common types of guarantees are advance payment guarantees, performance guarantees, and retention guarantees, each of which may be conditional or unconditional. The selection of appropriate guarantees is often influenced by the priorities of involved parties and prevailing regulatory constraints, reflecting the unique dynamics of different projects.

Advance payments to contractors are a prevalent practice, providing them with a portion of the project value prior to the commencement of work. However, to safeguard this funding, contractors are required to furnish an advance payment guarantee, which stipulates specific conditions under which payment can be invoked, thereby establishing a safety net for both parties involved.

Performance bonds play a pivotal role in ensuring compliance with contractual obligations and are commonly mandated in construction agreements. These bonds can be structured as demand guarantees, which empower the obligee to claim payment without the need for conditions, thus enhancing financial security and trust among stakeholders.

Disputes in road construction projects emerge from a multitude of factors, including the scale of the project, intricate contract issues, and communication barriers. Common sources of conflict often involve owner-related concerns, contractor competence, disputes among consultants, and ambiguities in design specifications.

When disputes arise, it is essential to approach their resolution constructively. Traditional methods such as arbitration and litigation should be seen as last resorts; instead, Alternative Dispute Resolution (ADR) methods like negotiation and mediation are preferred for their capacity to yield efficient and amicable resolutions.

The chapter places particular emphasis on disputes between employers and guarantors, especially in relation to demand guarantees. A notable challenge arises from the reluctance of banking institutions to honor these guarantees, which often escalates into legal proceedings and disputes that require resolution.

In Ethiopia, the absence of comprehensive legislation governing demand guarantees creates a complex legal landscape, necessitating reliance on general contract law. The chapter calls attention to the pressing need for new legislation tailored to address the distinct characteristics and challenges of demand guarantees.

The lack of uniformity in guarantee documentation can lead to significant confusion and complications in dispute resolution. In light of this, parties involved are encouraged to consider and refer to established international instruments for guidance, promoting clarity and consistency.

To further enrich the discussion, the chapter reviews a selection of court cases related to demand guarantees. These analyses highlight prevailing judicial practices and outcomes, displaying the courts' recognition of the intrinsic independence associated with unconditional guarantees, alongside the fundamental principles governing them.

## CHAPTER FIVE

### 5. CONCLUSION AND RECOMMENDATIONS

#### 5.1 Findings

**Lack of Comprehensive Legislation:** In Ethiopia, there exists a notable absence of a robust legal framework specifically addressing demand guarantees. This deficiency fosters a landscape fraught with ambiguity and inconsistency in judicial interpretations and practices. Current legislative provisions fail to adequately capture the unique nature of demand guarantees, which are vital instruments in the construction sector.

**Judicial Confusion:** Ethiopian courts frequently struggle to distinguish between demand guarantees and conditional guarantees, which undermines the fundamental purpose of demand guarantees: providing immediate financial security without the burden of extensive proof of default. This judicial confusion often precipitates unnecessary delays in the payment process and leads to prolonged legal disputes, ultimately hampering the efficiency of projects and the trust placed in financial mechanisms.

**Role of Banks and Insurances:** Banks and insurance serve as pivotal entities in the issuance of demand guarantees; however, their reluctance to honor these guarantees swiftly can precipitate significant legal challenges. Often, banks exhibit hesitance to comply with demands for payment, which leads to litigation and contentious disputes. This unwillingness can create a hostile environment for stakeholders, detracting from the intended purpose of demand guarantees and potentially destabilizing financial transactions within the construction sector.

**Need for Legal Alignment with International Standards:** The findings underscore an urgent need for Ethiopia's legal framework to evolve in alignment with international standards, such as the Uniform Rules for Demand Guarantees (URDG) and the United Nations Convention on Independent Guarantees. Such alignment would not only enhance the reliability and predictability of demand guarantees in Ethiopia but also foster a safer and more trustworthy environment for international and local investors. By adopting these frameworks, Ethiopia can

improve its legal landscape, significantly benefiting its economic growth and infrastructure development.

## **5.2 Conclusions**

The findings presented in this research paper indicate that Ethiopia lacks clear and comprehensive legislation specifically governing on-demand guarantees. This absence of regulatory clarity generates ambiguity regarding the legal treatment of these financial instruments. In the absence of definitive legislation, judicial interpretations of demand guarantees tend to vary significantly. Consequently, courts may encounter challenges in applying consistent standards, leading to confusion and inconsistency in case law concerning the enforcement of demand guarantees. The lack of precise definitions and guidelines may result in the conflation of demand guarantees with conditional guarantees, which possess distinct legal implications. Such misunderstandings further complicate the enforcement process for demand guarantees.

The decisions of Ethiopian courts and the procedures for resolving unconditional guarantee cases do not align with the Uniform Rules for Demand Guarantees (URDG). Ethiopian judiciary practices often fail to adhere to the principles advocated by the URDG, which emphasize the independence of demand guarantees from the underlying contractual obligations and the requirement to honor payments upon first demand without necessitating evidence of default. There is a tendency for courts to misinterpret the nature of demand guarantees, erroneously equating them with conditional guarantees. This conflation results in a requirement for beneficiaries to provide proof of default, contradicting the URDG's stipulations that demand guarantees should be honored upon demand. Furthermore, the procedural practices employed by Ethiopian courts in handling demand guarantee cases may not adhere to the streamlined processes recommended by the URDG, which can lead to prolonged litigation and uncertainty for the parties involved - contrary to the URDG's objective of facilitating expedient and efficient resolution.

The interpretations rendered by the high court frequently obscure the distinction between demand guarantees and conditional guarantees, thereby undermining the fundamental principles that delineate their respective functions. Such interpretations may culminate in decisions that

deviate from the intended purpose of demand guarantees, which are designed to ensure immediate payment upon request without necessitating proof of default. An analysis of pertinent court cases reveals that judges may apply similar standards and requirements to both forms of guarantees, failing to recognize the independent nature of demand guarantees. This oversight can result in inconsistent rulings and uncertainty for parties engaged in contractual agreements.

Moreover, the absence of standardized templates for demand guarantee documentation may lead to confusion and disputes, prompting banks to favor litigation as a means of resolving such issues. It has been observed that Ethiopian banks may unethically exploit the time value of money by delaying payment upon the beneficiary's first demand.

The research paper identifies critical distinctions between a demand guarantee and a conditional guarantee. A conditional guarantee necessitates that the beneficiary demonstrate the principal debtor's default to claim payment, whereas a demand guarantee permits the beneficiary to request payment upon simple demand, either without justification or with the presentation of specified documents. A demand guarantee operates independently of the underlying contract, in contrast to a conditional guarantee, which is contingent upon it. Furthermore, a conditional guarantee requires the beneficiary to furnish proof of the contractor's failure and any resulting losses to secure payment, while a demand guarantee does not impose such requirements. A demand guarantee is structured to provide immediate financial security without extensive evidence of default, whereas a conditional guarantee offers security solely in circumstances of a breach of the underlying contract. In the event of a dispute, demand guarantees are typically settled through a summary procedure, whereas conditional guarantees may necessitate a more prolonged litigation process to ascertain the validity of the claim.

### **5.3 Recommendations**

Establishing a robust legal framework governing demand guarantees in Ethiopia is imperative. The Ethiopian government must take decisive action to draft and enact comprehensive legislation that clearly delineates the nature, rights, and obligations of all parties involved in demand guarantees. This legislation should unequivocally recognize demand guarantees as independent instruments, distinct from conditional guarantees, to enhance legal certainty in commercial transactions.

The standardization of guarantee documents is not merely beneficial; it is essential for eliminating ambiguities that can lead to disputes. Banks and financial institutions should develop standardized templates for demand guarantees that adhere to international best practices. This uniformity will foster transparency and clarity in terms and conditions, ultimately benefiting all stakeholders involved.

Furthermore, embracing Alternative Dispute Resolution (ADR) mechanisms is a strategic move to alleviate the court system's burden and expedite dispute resolution processes. By actively promoting ADR methods, such as mediation and arbitration, for conflicts related to demand guarantees, Ethiopia can achieve quicker resolutions while significantly reducing costs in comparison to traditional litigation approaches.

It is crucial to align Ethiopian laws with respected international standards, such as the Uniform Rules for Demand Guarantees (URDG) and International Standby Practices (ISP98). The Ethiopian government should engage in strategic collaboration with prominent international organizations, including the International Chamber of Commerce (ICC) and UNCITRAL. Such partnerships will facilitate the adoption of best practices and provide invaluable insights for the development of effective legislation.

Finally, ensuring a consistent judicial interpretation of demand guarantees is vital for the integrity of the legal system. Ethiopian courts must adopt a cohesive approach to interpreting demand guarantees, particularly in distinguishing them from conditional guarantees. This consistency can be achieved through clear guidelines or directives from the Federal Supreme Court, reinforcing a stable legal environment that fosters confidence in the use of demand guarantees.

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## ANNEXES

### 1. Interview Guiding Questions & List of Interviewees

Interview Guiding Questions: These are **the key questions presented to the interviewees.**

- 1) Is there clear legislation governing on-demand guarantees in Ethiopia?
- 2) Are our court decisions and procedures for resolving cases involving unconditional guarantees consistent with the Uniform Rules for Demand Guarantees?
- 3) Does the High Court in Ethiopia differentiate between demand guarantees and conditional guarantees in its case handling?
- 4) Why do banks issuing demand guarantees in Ethiopia prefer litigation over making payments upon the first demand of the beneficiary?
- 5) What are the key differences between a demand guarantee and a conditional guarantee?
- 6) What are your thoughts on the recent developments made by the state to address these issues?

List of Interviewees:

- 1) Legal Service Director from Buuna Bank SC
- 2) Legal Service Director from *Hibret* Bank SC
- 3) Legal Service Director in Addis International Bank SC
- 4) Legal Service Director from Addis Ababa Road Authority (ACRA)
- 5) Legal Service Director from Ethiopian Roads Administration (ERA)
- 6) Claim Expert from Aser General Contractor
- 7) Claim Expert from Messay Oli General Contractor
- 8) Claim Expert from Kibish General Contractor

## 2. Informants' Perspectives and Information Collected

R N	Category of informants	Common Perspectives and Information Gathered	Date of Data Collection
1	Financial Sector (3 Banks)	<ul style="list-style-type: none"> <li>- In Ethiopia, there is currently no comprehensive legislation governing demand guarantees.</li> <li>- The contractual status of a guarantee document is disputable.</li> <li>- A demand guarantee is unconditional in relation to the underlying contract, but there may be specific conditions concerning the guarantee itself.</li> <li>- The status and applicability of the Uniform Rules for Demand Guarantees (URDG) are determined by the parties' agreement or by their adoption in the law of the state, which can vary in consistency.</li> <li>- A bank's failure to pay a demand guarantee upon the first request from the beneficiary constitutes a breach of contract. However, this situation may arise due to the substantial amount of money involved, liquidity constraints, the time value of money, and the minimal collateral value.</li> </ul>	From February 19 to February 26, 2025.
2	Road Construction Sector (2 Employers)	<p>They share a common view that there is no clear law governing demand guarantees in Ethiopia.</p> <ul style="list-style-type: none"> <li>- They suggest that cases involving unconditional guarantees should be handled through a summary procedure as per Article 284(b); however, in practice, courts typically conduct full-fledged trials.</li> </ul>	

		<p>-In an unpublished case file No 168954, the Court of Cassation based its decision on the URDG.</p> <ul style="list-style-type: none"> <li>- They argue that Courts often conflate demand guarantees with conditional bonds.</li> <li>- They accuse banks of being reluctant to pay demand guarantees, which goes against the principle of good faith.</li> </ul>	
<b>3</b>	Road Construction Sector (3 Contractors)	-Claim Experts from the three contracting companies have expressed that they lack a comprehensive understanding of the issues surrounding demand guarantees.	