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## THE ETHIOPIAN 'LAW OF DEMAND GUARANTEES': THE EXCEPTIONS TO THE OBLIGATION TO PAY ON DEMAND?

Addis Gemechu Argo\*

### Abstract

*Despite the widespread use of demand guarantees, also known as unconditional bank guarantees, a comprehensive legal framework regulating the same is barely available in Ethiopia. As a result, the operation and enforcement of demand guarantees are marred with legal uncertainty. The doctrine of autonomy, one of the principles governing demand guarantee, provides that payment of demand guarantee should be honored immediately. From the principal's perspective, the doctrine of autonomy is unpleasant as it paves the way for payment of unjustified calls of guarantee. To deal with this discontent, in other jurisdictions, certain exceptions have been allowed. This Article tries to explore the kind of exceptions allowed under Ethiopian laws while entertaining unjustified calls of a demand guarantee. With a view to give a clear picture of legal aspects of demand guarantees, the Article tries to analyze the existing legal frameworks and relevant literature. By examining demand guarantee and the subsequent calls in light of law of contract and principles of law, this Article argues, in Ethiopia, demand guarantee calls tainted with fraud and illegality should be declined. To limit the scope of such exceptions and thereby maintain integrity of demand guarantees, it is also stated that what constitutes fraud and illegality should be construed narrowly. It is further recommended that admission or rejection of call of demand guarantees must be addressed under explicit provisions of the guarantee, the principle of contracts and case laws to the extent applicable. This will bring about predictability in the issuance and operation of demand guarantees which is dearly required in an emerging financial industry.*

**Keywords:** *Demand guarantees, fraud exception, illegality, principle of autonomy*

### I. INTRODUCTION

Risks of non-performance of contracts have dictated the need for security which is particularly common in the absence of previously established relationships. Such security may take the form of demand guarantees by which a bank pledges to compensate a beneficiary when the principal defaults. A demand guarantee, which assumes a form of unconditional payment obligation, is used as security for contractual default in connection with the supply of goods,

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\*Former Lecturer at University of Gondar, School of Law. He is currently Manager for Legal Advisory Division at Bunna International Bank S.C. The author can be reached through [adifenet@gmail.com](mailto:adifenet@gmail.com).

technology transfer, tender, loans, leases, and other financial transactions.<sup>1</sup> Demand guarantees offer strong security and confidence to enter into international contracts where there are geographical barriers and possible protracted litigation. This is attributable to the nature of the demand guarantee that dictates immediate payment without any argument. However, it has become questionable if every call of demand guarantee has to be admitted. In this regard, some maintain that the autonomous character of a demand guarantee may be a cause for concern as it denies any possibility of declining payment requests.<sup>2</sup> This nature of demand guarantee could invite unscrupulous beneficiary to call guarantee on grounds unrelated to the guarantee.<sup>3</sup> This has dictated the need to introduce exceptions that justify a rejection of the call for confiscation of unconditional guarantee.<sup>4</sup>

Demand guarantees are among the instruments that are widely used by customers of banks in Ethiopia.<sup>5</sup> Despite the absence of an explicit normative framework regarding the subject, the extensive use of demand guarantee and its involvement in several court cases<sup>6</sup> present an opportunity to examine and analyze the operation and enforcement of the instrument. It is against this backdrop that this paper attempts to look into the definition, nature, and enforcement of demand guarantees under Ethiopian law. In particular, inquiries into the conditions that warrant rejection of call of demand guarantees are thoroughly made by having reference to literature, court cases, and relevant legislation. The scope of such exceptions is also entertained. Due to the dearth of literature on the area of demand guarantees, discussions are mainly based on scholarly articles from other jurisdictions.

The remaining part of this paper is organized in five sections. In section II, the paper highlights the definition and distinguishing features of demand guarantees, parties to demand guarantees, types of guarantees, and the governing principle of demand guarantees. Section III tries to examine the place of demand guarantee under Ethiopian law and identifies, if any, the laws applicable to demand guarantees. Under section IV, the source of obligation to pay on demand is analyzed by having regard to the Ethiopian context. Section V reviews exceptions to the principle of autonomy and whether such exceptions apply to the context of Ethiopia. In particular, this section attempts to depict how these exceptions can be enforced. Finally, section VI provides conclusion and recommendations.

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<sup>1</sup>Michelle Kelly-Louw, *Selective Legal Aspects of Demand Guarantee*, (Unpublished, Doctoral Thesis, University of South Africa, October 2008), at.20.

<sup>2</sup>Thanuja Rodrigo, *Mitigating the Risk of Unfair Calling on Demand Guarantees in the Sri Lankan Market*, 8(10) MACQUARIE JOURNAL OF BUSINESS LAW 222, 224(2011).

<sup>3</sup>*Id.*

<sup>4</sup>Michelle Kelly-Louw, *Illegality as an Exception to the Autonomy Principle of Bank Demand Guarantees*, 42(3) THE COMPARATIVE AND INTERNATIONAL JOURNAL OF SOUTH AFRICA 340, 350(2009).

<sup>5</sup>Letter of guarantees constitutes significant part of banking business. For instance a look at Dashen Bank's Annual report for the FY reveals that, among list of reported contingent liabilities guarantee stands at Birr 16,712,697,000.00 (see Dashen Bank S.C. Annual Report 2020). See also guarantee liability of Bunna Bank S.C. as reported in 2020 which stood at Birr 3,330,813,000.00(See Bunna Bank S.C Annual REPORT 2020).

<sup>6</sup>See Supra note 55, 57, 72, 77 & 82 below.

## II. DEMAND GUARANTEES: DEFINITION, PARTIES AND DOCTRINE OF AUTONOMY

### A. Definition

Demand guarantee, that has evolved with international contractual obligations involving large financial risks<sup>7</sup>, is a documentary promise by a bank wherein an obligation to pay arises upon first demand provided that the request is submitted in the prescribed form within the validity period of the guarantee.<sup>8</sup> A bank, on account of principal, unconditionally commits itself to pay a certain sum of money to a person called beneficiary who might lodge payment requests when it deems the contract with the principal is not performed.<sup>9</sup> In terms of liquidity, demand guarantee is as good as cash for the beneficiary.<sup>10</sup>

In consonance with the above definition, the International Chamber of Commerce (ICC) has defined demand guarantees as unconditional payment undertakings. Under the latest issue of Uniform Demand Guarantee Rule (hereinafter URDG 758), it is provided that demand guarantee is any signed undertaking providing for payment on presentation of a complying demand.<sup>11</sup> It is a document that authorizes the beneficiary to request payment without a need to justify the legitimacy of the demand.<sup>12</sup>

In terms of purpose, demand guarantee was introduced to address insecurity of non-performance of obligations by furnishing immediate and easy access to funds that are required to remedy probable default.<sup>13</sup> Purchasers and employers that fear risks of non-performance will usually require indemnity that can be paid without further court proceedings. In this regard, demand guarantees have proved to be reliable instruments as issuing banks would be compelled to pay without argument.<sup>14</sup> Through demand guarantee, a contracting party's performance obligation will be substituted by a more reliable entity that unconditionally promises to compensate for damage sustained due to the default of the former.<sup>15</sup> Demand guarantee ensures the continuation of projects which might otherwise be held-up due to shortage of funds.<sup>16</sup> Such consideration of immediate payment makes demand guarantee more appealing in international transactions where possible issues of conflict of law make litigation expensive and protracted.<sup>17</sup>

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<sup>7</sup>JASON CHUAH, *LAW OF INTERNATIONAL TRADE: CROSS-BORDER COMMERCIAL TRANSACTIONS*, (Sweet & Maxwell Ltd -4<sup>th</sup> ed. 2009), at 517-519.

<sup>8</sup>Kelly –Louw, *supra note 1*, at 17.

<sup>9</sup>Rolf Meyer-Reuman, *Rights and Obligations in the Event of Bank Guarantee Being Called in Governmental Projects*, 17(1) ARAB LAW QUARTERLY 28, 28(2002).

<sup>10</sup>Kelly –Louw, *supra note 1*, at 161.

<sup>11</sup>ICC Publication, *Uniform Demand Guarantee Rules (URDG 758)*, July 2010, Art 2 paragraph (13), available at <https://store.iccwbo.org/icc-uniform-rules-for-demand-guarantees-urdg-758.pdf> (Accessed on July 19, 2018).

<sup>12</sup>Kelly –Louw, *supra note 4*, at 3.

<sup>13</sup>Kolawale Mayomi, *The Case for Analytical Construction and Enforcement of Demand Guarantees in Nigeria*, 7(2) AFE BABALOLA UNIVERSITY JOURNAL OF SUSTAINABLE DEVELOPMENT LAW AND POLICY 248, 250(2016).

<sup>14</sup>Chung Hsin Hsu, *The Independence of Demand Guarantees, Performance Bonds and Standby Letter of Credits*, 1 (2) NATIONAL TAIWAN UNIVERSITY LAW REVIEW 1, 4(2006).

<sup>15</sup>*Id.*

<sup>16</sup>Kelly –Louw, *supra note 1*, at 20.

<sup>17</sup>*Id.*

Generally, it is evident that unconditional promise to secure an undertaken obligation is the defining characteristic of demand guarantee. Depending on the type of obligation to be guaranteed, demand guarantees may assume different specific names. For example, a demand guarantee that is issued to ensure that a bidder does not withdraw or alter its tender is commonly known as tender guarantee (bid bond).<sup>18</sup> A demand guarantee to ascertain a contractor has timely and completely fulfilled its obligation under a contract is called performance guarantee.<sup>19</sup> A demand guarantee to remedy any defect, which may become apparent after delivery of goods or completion of a project, is called maintenance/retention or warranty guarantee.<sup>20</sup> Maintenance guarantee is usually a form of guarantee that contractors and/or exporters are required to present before the conclusion of a construction contract and/or international sale of goods respectively.<sup>21</sup> Moreover, advance payment guarantee is another form of demand guarantee that can be issued to warrant repayment of advance payment disbursed to contractor/supplier.<sup>22</sup> To further clarify demand guarantees, a brief discussion concerning parties involved is in order.

### B. Parties to Demand Guarantee

Demand guarantee usually involves three parties: the principal, guarantor, and beneficiary.<sup>23</sup> It is initiated by a person called the principal (instructing party) who instructs a bank for the issuance of demand guarantees that secures the performance of an obligation.<sup>24</sup> The principal could be a seller, exporter, contractor or any other person who possibly has a non-contractual underlying obligation to be guaranteed.

As referred under the URDG 758, a guarantor<sup>25</sup> is a party who issues a demand guarantees thereby undertaking to indemnify the beneficiary if the principal defaults in his obligation emanating from the underlying contract. Put in another way, the guarantor ensures the solvency of the principal.<sup>26</sup> The URDG 758 defines a beneficiary as a party in whose favor the demand guarantee is issued.<sup>27</sup> The beneficiary has direct contractual relationships with the principal. Generally, demand guarantees may involve three separate contracts that, however, give rise to tripartite relationships.<sup>28</sup> These contracts are the underlying contracts between principal and beneficiary, the contract between the principal and his bank (also called indemnity contract), and the contract established between the bank and beneficiary created by the issuance of demand guarantee. As stated above, each of the contractual relationships created by the demand

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<sup>18</sup>ROELAND V.F. BERTRAMS, *BANK GUARANTEES IN INTERNATIONAL TRADE: THE LAW AND PRACTICE OF INDEPENDENT GUARANTEES AND STANDBY LETTER OF CREDITS IN CIVIL LAW AND COMMON LAW JURISDICTIONS*, (Kluwer Law International -3<sup>rd</sup> ed. 2004), at 38.

<sup>19</sup>*Id.*

<sup>20</sup>*Id.*, at 40.

<sup>21</sup>*Id.*

<sup>22</sup>*Id.*

<sup>23</sup> Sometimes, a counter guarantor might be involved to make the number of parties four. This is mostly applicable in international contracts whereby the beneficiary seeks local guarantor that counter guarantees the guarantee issued by foreign bank.

<sup>24</sup> Kelly –Louw, *supra* note 1, at 21.

<sup>25</sup> ICC Publication, *Uniform Demand Guarantee Rules (URDG 758)*, *supra* note 11, Art. 2, paragraph 19.

<sup>26</sup>HsinHsu, *supra* note 14, at 3.

<sup>27</sup> ICC Publication, *Uniform Demand Guarantee Rules (URDG 758)*, *supra* note 11, Art.2, paragraph 5.

<sup>28</sup> Kelly –Louw, *supra* note 1, at 21.

guarantee is independent of each other. The underlying contract governs the contractual relationship between the principal and beneficiary.<sup>29</sup> The second contract is the one formed by a letter of guarantee (demand guarantee). It creates the duty of the bank towards the beneficiary. Payment based on the demand guarantee brings into light the significance of the third contract called indemnity contract.<sup>30</sup> This contract is formed between the principal and the bank whereby the latter agrees to guarantee an obligation of a given limit in exchange for payment of a certain amount of commission. It entitles the guarantor to resort to the sale of pledged/mortgaged properties of the principal if it is forced to pay the guaranteed money.

### C. The Principle of Autonomy as a Unique Feature of Demand Guarantees

A fundamental characteristic of demand guarantee is reflected in what has become known as an ‘autonomy doctrine’ or ‘principle of independence’.<sup>31</sup> Regardless of whether or not the principal is in breach of the underlying contract, the doctrine dictates that the guarantor should pay if the demand is duly presented.<sup>32</sup> Thus, the guarantor cannot decline to make payment to the beneficiary on account of reasons related to the underlying contract.<sup>33</sup> The principle of autonomy is also well recognized under the URDG 758<sup>34</sup>, which may apply to the operation of the guarantee provided that the users and issuers choose it as an applicable rule.<sup>35</sup>

A demand guarantee is also independent of the indemnity contract. As a result, the guarantor cannot refuse payment due to the principal’s failure, for instance, to deposit the necessary funds into the account of the guarantor.<sup>36</sup> As the indemnity contract is external to the guarantee, it has no significance in barring the guarantor’s obligation to pay the guarantee money.<sup>37</sup> The autonomous character of demand guarantee primarily emanates from the guarantee letter.<sup>38</sup> The validity period of the guarantee, the maximum amount of guarantee and conditions of payment exclusively depend on the contents of the letter of guarantee.<sup>39</sup>

## III. REGULATION OF DEMAND GUARANTEES UNDER ETHIOPIAN LAW

Despite its widespread use, demand guarantee is one of the under-regulated areas of law in Ethiopia. It is not even clear from where financial institutions have found the authority to issue demand guarantees. In this regard, Articles 2(2) (f) and 7 of Banking Business Proclamation No.

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<sup>29</sup>*Id.*

<sup>30</sup>*Id.*, at 22.

<sup>31</sup>Michelle Kelly –Louw, *supra* note 4, at 346. See also ICC Publication, *Uniform Demand Guarantee Rules (URDG 758)*, *Supra* note 8, Art.5 (a).

<sup>32</sup>*Id.*, p.346. See also United Nations Convention on Independent Guarantees and Standby Letter of Credit, Dec. 11, 1995, 38030 U.N.T.S, 2169, Art.2 -3.

<sup>33</sup>*Id.*

<sup>34</sup>It is the latest ICC’s publication that provides rules for the issuance and operation of demand guarantees. Since its inception in 1991, successive ICC rules on demand guarantees have secured acceptance among bankers, traders, international organizations such as World Bank, UN Commission on International Trade Law (hereinafter UNCITRAL). For instance, the current edition, URDG 758, has gained formal endorsement from UNCITRAL.

<sup>35</sup>ICC Publication, *Uniform Demand Guarantee Rules (URDG 758)*, *Supra* note 11, Art.5 (a).

<sup>36</sup>Kelly –Louw, *supra* note 4, at 346.

<sup>37</sup>*Id.*

<sup>38</sup>ICC Publication, *Uniform Demand Guarantee Rules (URDG 758)*, *Supra* note 11, Art. 12.

<sup>39</sup>*Id.*

592/2008 which categorize customary banking business as work of banks coupled with other arguments based on implied recognitions may be raised as an authority.<sup>40</sup> The extensive use of bank guarantees in Ethiopia maybe considered enough to take it a customary banking business.

It has been also argued that the prohibition of issuance of certain types of bonds by Insurance Companies Directive No.SIB/24/2004 as amended by Directive No. SIB/51/2020 (here after, NBE Directive No. SIB/24/2004) which, as of principle<sup>41</sup>, prohibits insurance companies from issuing ‘financial’ and ‘unconditional’ bonds and remains silent concerning banks is implied recognition.<sup>42</sup> Furthermore, the explicit and implicit inclusion of bank guarantees under their Memorandum and Articles of Association, which are approved by NBE, provides legal recognition for the issuance of bank guarantees. Apart from these, express reference to demand guarantees has been made in different legislation and few court decisions. The following section provides further detail on the place of demand guarantees under Ethiopian law.

### **A. Civil Code: Applicability of the Provisions on Contracts in General and Surety ship**

It has been asserted that demand guarantees are payment undertakings that do not fall within the scope of ordinary contract principles as they do not fit the definition of a contract.<sup>43</sup> This is mainly because demand guarantees do not involve the traditional requirements of offer and acceptance of contracts. They will only become binding by the issue of the guarantee subject to the beneficiary’s acceptance.<sup>44</sup> However, failure of the beneficiary to reject the issued guarantee is deemed as an acceptance.<sup>45</sup> As separated from contracts, demand guarantees are undertakings developed by usage of merchants that takes force by their issuance without further formality requirements.<sup>46</sup> As a result, it has been argued that the absence of a recognized form of acceptance and offer should not exclude demand guarantee from the ambit of the law of contract.<sup>47</sup> In demand guarantees, there is a prevailing customary rule that the beneficiaries do not expressly notify the issuing bank as to their acceptance of the guarantee.<sup>48</sup> They rather simply receive the guarantee letter which can be considered as ‘acceptance’<sup>49</sup> The absence of conventional offer and acceptance is therefore down to the nature of demand guarantees.<sup>50</sup> The assumption that all contracts require an offer and acceptance have been criticized for it lacks

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<sup>40</sup>Yared Siyoum, *The Law Governing Unconditional (First Demand –Independent) Bank Guarantees*, (Unpublished LLM Thesis, Addis Ababa University, School of Law, 2017), at 39.

<sup>41</sup>See NBE Directive No. SIB/24/2004, Art 2(3) (as amended by NBE Directive No. SIB/51/2020), that exceptionally permits issuance of unconditional bonds by Insurance Companies.

<sup>42</sup>Yared, *supra note* 40, at.40.

<sup>43</sup>Roy Goode, *Abstract Payment Undertakings in International Transactions*, 22(1) BROOKLYN JOURNAL OF INTERNATIONAL LAW 1, 3(1996).

<sup>44</sup>*Id.*

<sup>45</sup>Charl Hugo, ‘*Documentary Credits: The Basis of the Bank’s Obligation*’, 117(2) SOUTH AFRICAN LAW JOURNAL 224, 255(2000).

<sup>46</sup>J.P VAN NIERKERK AND W.G. SCHULZE, *THE SOUTH AFRICAN LAW OF INTERNATIONAL TRADE: SELECTED TOPICS*, (SAGA Legal Publications, 2<sup>nd</sup>ed. 2006), at, 303.

<sup>47</sup>*Id.*

<sup>48</sup>*Id.*

<sup>49</sup>Goode, *supra note*43, at.4.

<sup>50</sup>*Id.*

practical applicability all the time and in all circumstances.<sup>51</sup> Generally, the categorization of demand guarantee as a contract or otherwise should be given little weight as long as one accepts the binding force of such undertakings.<sup>52</sup>

In Ethiopia, some have argued against the contractual nature of demand guarantees. It is provided that applicability of the Civil Code provisions on contracts to a letter of guarantee is questionable as the later fails to fulfill form requirements prescribed for guarantee contracts.<sup>53</sup> It is also added that letter of guarantee falls short of the fundamental elements of a contract, such as signature of the parties and witnesses, to be governed by the Civil Code.<sup>54</sup> This argument, however, fails to recognize the special nature of demand guarantee which makes it a special contract that takes binding force on first demand. In its decision related to the legal nature of the unconditional letter of guarantees, the Federal Supreme Court Cassation bench stated that the argument denouncing the contractual nature of such instruments is inconsiderate of NBE Directive No. SIB/24/2004.<sup>55</sup> Under Article 1 of the directive, an unconditional letter of guarantee is an instrument prepared and issued by a party who undertakes to pay the debt of another party.<sup>56</sup> As such, as far as the other party has accepted and acted based on such document, the mere absence of signature will not affect the contractual nature of the demand guarantee. Furthermore, a view that denies the contractual nature of a letter of guarantees for the requirements of witness signature has failed in light of Stamp Duty Proclamation No.110/1998.<sup>57</sup> Under Article 2(2) of this Proclamation, it is provided that '*bond*', a generic nomenclature that includes a letter of guarantees, can be issued with or without attestation of witnesses.

The other issue worth considering is if the provisions of the Civil Code on the ordinary guarantee (surety) would apply to demand guarantees. In this regard, it is said that the interdependence of the main obligation and guarantor's obligation, which is unknown to demand guarantees, poses the difficulty of applying such provisions to demand guarantees.<sup>58</sup> It is further contended that, unlike demand guarantees where the principal is required to pay commission, the gratuitous nature of surety shows the incompatibility of the Civil Code provisions to demand guarantees.<sup>59</sup> Article 1942(1) of the Civil Code is also raised as one of the provisions containing attributes that do not conform to the nature of demand guarantees.

The literal reading of Article 1942 (1) of the Civil Code conveys that a guarantor has the right and duty to set-up against a creditor all defenses available to the debtor which is hardly

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<sup>51</sup> Shawn J. Bayern, *Offer and Acceptance in Modern Contract Law: A Needless Concept*, 103(1) CALIFORNIA LAW REVIEW 67, 101(2015).

<sup>52</sup> *Id.*

<sup>53</sup> GEZU AYELE, የኢትዮጵያ የባንክ እና የሚተላለፉ የንግድ ሰነዶች ሕግ፣ አንደኛው አገም፣ 2017፣ at.102. The argument herein is based on Article 1725 & 1727 of the Civil Code which require contract of guarantee to be made in written form and attested by two witnesses.

<sup>54</sup> *Id.*

<sup>55</sup> *Africa Insurance S.C v. Commercial Bank of Ethiopia*, FED. SUPREME CT. CASS. BEN., File No 36935 (Decision of 27 February 2004 E.C), Federal Supreme Court Cassation Decisions (Hidar 2005), Vol. 13, at .388.

<sup>56</sup> *Id.*

<sup>57</sup> *Africa Insurance vs. Dashen Bank S.C*, FED. SUPREME CT. CASS. BEN., File No. 40186 (Decision of 27 February 2004 E.C), Federal Supreme Court Cassation Decisions (Hidar 2005), Vol.13 at 402.

<sup>58</sup> GEZU, *supra note* 53, at.102.

<sup>59</sup> *Id.*, at 103.

available in case of demand guarantees. One may, however, wonder if the last phrases of Article 1942(1) are meant to, indirectly, recognize demand guarantees. The provision reads as “the guarantor has the right and duty to set up against the creditor all defenses available to the principal debtor, unless they are *excluded by the nature of his guarantee*.” The phrase “.....*excluded by the nature of his guarantee*” seems to imply that there are certain aspects of the guarantee which proscribe the guarantor from raising defenses available to the debtor. This characteristic of guarantee has the effect of isolating the surety from the main contract thereby sharing traits of the autonomy principle. Thus, one may argue that the law is leaving room for issuance of unconditional guarantees as it resembles the autonomy principle that envisages the exclusion of possible defenses from the main contract.<sup>60</sup>

Generally, the applicability of general principles of the law of contract has too much practical significance. Its gap-filling role should not be undermined in cases where the express or implied terms of the guarantee fail to deliver the required solution to a given legal problem.<sup>61</sup> This would not only address the legal gap, but also encourages demand guarantee transactions as it maintains predictability in terms of the applicable normative framework.

## B. Other Legislations and Court Decisions

Explicit reference to demand guarantee is rarely available in the laws of Ethiopia. One such reference is, however, made under Article 1 paragraph 4 of the NBE Directive No. SIB/24/2004 with a different nomenclature: ‘unconditional bond’ to be issued by insurance companies. The fact that ‘unconditional bond’ is defined as an instrument to be paid on demand without any precondition indicates that the very concept of demand guarantee is known to the Ethiopian legal system.<sup>62</sup> This directive is widely used by courts in conceptualizing the instrument.<sup>63</sup> It mainly affirms the principle of independence with respect to letter of guarantee which is important in clearing out the nature of ‘unconditional guarantee’ as understood in Ethiopia.

Apart from this, other relevant proclamations can be identified concerning demand guarantees. The first one is the Stamp Duty Proclamation No.110/1998 which refers to bonds under Article 2(2). In this Proclamation, ‘bond’ is defined as an instrument by which a person obliges himself to pay money to another on performance or non-performance of a specific act. Another reference to the demand guarantee is made under Article 2(20) of the Federal Government of Ethiopia Financial Administration Proclamation No. 648/2009 which defines ‘security’ as any documentary undertaking to perform financial obligation which might include treasury bill, promissory note, and bond. As this provision embraces the ‘undertaking’ nature of demand guarantees, it has been instrumental in serving courts to conceptualize various types of

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<sup>60</sup>*Id.*, at.37.

<sup>61</sup>Michelle Kelly –Louw, *The Law Applicable to Demand Guarantee and Standby Letters of Credit*, 24(2) UNIVERSITY OF FORT HARE, SPECULUM JURIS 1, 2( 2010).

<sup>62</sup>National Bank of Ethiopia, *Directive Number SIB/24/2004*, Art.3 & 4 (2004).

<sup>63</sup>*Africa Insurance S.C v. Commercial Bank of Ethiopia*, *supra* note 53. See also *Africa Insurance v. Dashen Bank*, *supra* note 57. The decisions have also pinpointed the applicability of the Civil Code provisions to financial guarantee and performance bonds.



bonds issued by insurance companies.<sup>64</sup> Since these proclamations are used in dealing with the form requirements of bonds,<sup>65</sup> this can be taken as legal recognition of demand guarantee.

Albeit with no express definition, explicit reference to bank guarantee is also made under the Customs Proclamation No. 859/2014, which gives us additional reason to believe that the concept of demand guarantee is not new to the Ethiopian law. In stating admissible forms of security, Article 118(1) of the Customs Proclamation refers to ‘bank guarantees’. More importantly, Article 119(3) of this Proclamation insulates the guarantee from the underlying contract and bars the guarantor from raising any defense.

The Federal Supreme Court has made use of the above legislation in resolution of various disputes concerning demand guarantees which, in some way, indicates how letter of guarantees should be entertained under Ethiopian legal system.<sup>66</sup> The type of instruments subjected to litigation might not be bank guarantees per se. However, the issues raised in the process have significance to the regulation of demand guarantees.

Among several other issues, the applicability of suretyship provisions of the Civil Code to financial guarantees and performance bonds drawn by insurance companies was litigated in case of *Africa Insurance vs. Ethiopian Commercial Bank*<sup>67</sup>, *Africa Insurance vs. Dashen Bank S.C*<sup>68</sup> and *Ethiopian Insurance Corporation vs. Bale Rural Development Enterprise*.<sup>69</sup> While affirming the applicability of provisions of the Civil Code in all of these cases, the Federal Supreme Court relied on the very purpose of such instruments which is to guarantee an obligation undertaken by third parties. Both in terms of content and purpose, the financial bond/performance bond was given to secure the obligation of third parties resembling surety as regulated under the Civil Code.<sup>70</sup> It is this notable trait shared by financial/performance bond and surety that has been extensively elaborated in the stated decisions, persuaded the court to conclude that the provisions of the Civil Code apply to financial/performance bonds.

Given the nature of issues involved, the ruling of the court has stressed the undertaking nature of the guarantee. However, further scrutiny of the cases reveals that, at least in two of these cases<sup>71</sup>, the nature of the litigated guarantee instrument is ‘unconditional’ in nature. As a result, it can be said that the court has analyzed ‘unconditional guarantees’ in the context of the provisions of the Civil Code. The Court’s analysis and ruling reveal the possibility of utilizing, the provisions of surety in the resolution of disputes relating to demand guarantee.

In another case entertained by the Federal Supreme Court Cassation Bench, the legal effect of unconditional bank guarantee is litigated. In this case, the applicant (principal) argued against

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<sup>64</sup>*Id.*

<sup>65</sup>*Id.*

<sup>66</sup>*Id.*

<sup>67</sup>*Africa Insurance S.C v. Commercial Bank of Ethiopia, supra note 55.*

<sup>68</sup>*Id.*

<sup>69</sup>*Ethiopian Insurance Corporation v. Bale Rural Development Enterprise, FED. SUPREME CT. CASS. BEN., File No 47004 (Decision of 11 March 2004 E.C), Federal Supreme Court Cassation Decisions (Hidar 2005), Vol. 13, at 392.*

<sup>70</sup>*Id.*

<sup>71</sup>*Africa Insurance S.C vs. Commercial Bank of Ethiopia, supra note 55, at. 383 and see also Africa Insurance vs. Dashen Bank S.C, supra note 57, at 402.*

the lower court's decision that declared payment of unconditional bank guarantee without a need to prove non-performance of the underlying contract.<sup>72</sup> By emphasizing the applicant's clear undertaking towards issuance of an unconditional guarantee, the court declined the request to bar payment of the guarantee.<sup>73</sup> The court reasoned out that the applicant cannot defy its agreement by conditioning payment of the guarantee to non-performance of the underlying obligation.<sup>74</sup>

The court might have failed in clearly establishing the legislative source of unconditional bank guarantees. However, it is a groundbreaking decision in terms of determining the legal effect of unconditional demand guarantees. It has reaffirmed the principle of independence.<sup>75</sup> The principle of freedom of contract can also be raised as a legal base for the acceptability of demand guarantee under Ethiopian law. Subject to mandatory legal rules, contracting parties are free to determine the object and nature of their contracts.<sup>76</sup> Accordingly, parties can set up an instrument that creates rights and duties.

From the above discussion, it can therefore be said that the Ethiopian legal system is devoid of an organized body of law that applies to definition, issuance, and payment of demand guarantees. However, it is not alien to unconditional guarantees that are found, in a scattered manner, across different legislation.

#### IV. CALLING OF DEMAND GUARANTEES: THE SOURCE OF OBLIGATION TO PAY ON DEMAND

The name 'demand guarantee' is indicative of the guarantor's obligation to pay on demand which mainly emanates from clauses of guarantee letter that envisage immediate payment of the guarantee.<sup>77</sup> In this regard, most demand guarantees are quoted stating "...*unconditionally and irrevocably to guarantee as primary obligator and not as surety merely*...." thereby dictating immediate payment without opposition. The issuing bank has to, therefore, pay upon demand of the beneficiary. In other words, the banker has an 'absolute' obligation to pay irrespective of any dispute related to the underlying contract. It is due to this that demand guarantees are, sometimes, said to be 'as good as cash'.<sup>78</sup>

In Ethiopia, all instruments issued under the title 'unconditional bank guarantees' are construed based on the doctrine of autonomy.<sup>79</sup> This emanates from the letter of the guarantee which serves as a contract between the guarantor and the bank. In this regard, a look at the following extract of a certain demand guarantee would give us good insight.

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<sup>72</sup>*Trade Path International PLC v. Turkish Airlines* (two persons), FED. SUPREME CT. CASS. BEN., File No168954 (05 November 2019 G.C), (Unpublished).

<sup>73</sup>*Id.*

<sup>74</sup>*Id.*

<sup>75</sup>*Id.*

<sup>76</sup>GEORGE KRZUNOWICH, FORMATION AND EFFECTS OF CONTRACTS IN ETHIOPIAN LAW (Faculty of Law, Addis Ababa University) (1983), at.8.

<sup>77</sup> *Ethiopian Roads Authority v. Buna International Bank*, FED HIGH CT, File Number, 179253, (03 August 2016), (Unpublished) See also *Trade Path International PLC v. Turkish Airlines*, *supra note 72*.

<sup>78</sup> Kelly-Louw, *supra note 1*, at 161.

<sup>79</sup>*Id.*, p.41, See also *Ethiopian Roads Authority v. Buna International Bank*, *supra note 77*.

...We the bank, as instructed by the distributor, agrees **unconditionally** and **irrevocably** to guarantee as primary obligator and not as surety merely, the payment to the principal on **its first demand** without whatsoever right of objection on our part and without its first claim to distributor...<sup>80</sup>

The terms of the above letter of the guarantee are clear enough in conveying the message that the beneficiary is entitled to immediate payment. As a result, it affirms the doctrine of independence. As the paying bank is barred from raising any objection based on the underlying contract, the beneficiary is not supposed to prove the default of the principal. Moreover, the Federal Supreme Court Cassation bench has affirmed that unconditional bank guarantees are payable upon demand regardless of the objection of the principal.<sup>81</sup>

Be the above as it may, the guarantor may decline payment based on terms of the guarantee itself that have provided certain conditions. For instance, despite being captioned as unconditional, demand guarantees may require deposit of funds which will otherwise bar payment of the guarantee.<sup>82</sup> Hence, it should be noted that the autonomy principle detaches the guarantee from the underlying contracts and not from the letter of the guarantee itself. Terms of demand guarantee, therefore, constitute important rules of regulation in so far as payment and rights and duties of the parties are concerned.

From the principal's perspective, the principle of autonomy is unpleasant as it paves the way for immediate payment of the guarantee even during unjustified calls.<sup>83</sup> To deal with an unscrupulous beneficiary, almost all jurisdictions have allowed certain exceptions.<sup>84</sup> For example, fraud and illegality have been mentioned as exceptions to the principle of autonomy.<sup>85</sup> On the other hand, there is a fear that such exceptions may expand to the extent of undermining confidence in the use of demand guarantee.<sup>86</sup> Thus, it is important to strike a balance between the need to stop the unfair calling of guarantees and the need to maintain the integrity of demand guarantees.

## V. EXCEPTION TO THE PRINCIPLE OF AUTONOMY: IS IT AVAILABLE UNDER ETHIOPIAN LAW?

As indicated above, the principle of autonomy is one of the principles that undergird the operation of demand guarantees. Due to this principle, guarantors have limited options to refuse payment and the role of courts to give an order for the stoppage of payment is restricted.

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<sup>80</sup> Guarantee letter Issued by Bunna International Bank S.C Mekele Branch in favor of Ethio-Telecom, dated February 10, 2017, Reference No. 002022.

<sup>81</sup> *Trade Path International PLC v. Turkish Airlines*, *supra* note 72.

<sup>82</sup> Oromia Health Bureau v. Alburuj Genereal Trading PLC (two persons), FED HIGH CT, File Number 138786, (26 May 2014 ), (Unpublished).

<sup>83</sup> Kelly –Louw, *supra* note 1, at.328

<sup>84</sup> *Id.*, at 350.

<sup>85</sup> *Id.*

<sup>86</sup> Berhanu Beyene, በፍርድ ቤቶች ጊዜያዊ የእግድ ትዕዛዝ ከጥቅም ውጪ የሆነው የዋስትና ሰነድ፣ ETHIOPIAN REPORTER (Amharic Version), Nov. 15, 2015, Vol.21, No.162, at 46. See also Kelly-Louw, *supra* note 1, at. 323.

The principle of autonomy may, however, be overruled only in exceptional circumstances.<sup>87</sup> It has been said that vigorous misuse of the rights emanating from guarantee letter or fraud by a beneficiary, and payment requests for reasons unrelated to the guaranteed obligation shall constitute reasons to scrutinize if the guarantee has to be paid at sight.<sup>88</sup> In such cases, the principal debtor is advised to apply for an injunction from competent courts to stop payment.<sup>89</sup> Despite the general practice of admitting call of demand guarantee, there are few instances where payment requests might be rejected by banks.<sup>90</sup> These are when the calls are made contrary to letter of guarantee and to the matters unrelated to underlying obligations on account of which the guarantee is issued.<sup>91</sup>

The practice of employing injunction orders against the alleged unfair calling of guarantee is also pursued in Ethiopia.<sup>92</sup> However, orders restraining payment of demand guarantees have hardly implicated concrete grounds of granting injunctions. Furthermore, it is not clear if the banks have clear rules in defying payment requests. These will seriously compromise predictability and certainty that are dearly required in modern business transactions. It may also affect the trust of the business community towards demand guarantees and affect the integrity of the document as a security device.<sup>93</sup> Scholarly articles written on the subject dictate that exceptional circumstances such as blatant and vigorous misuse of rights emanating from guarantee may justify bank's failure to comply payment request of demand guarantees.<sup>94</sup> For the sake of predictability, it is important to have a clear picture of what legitimately stops immediate payment of demand guarantees. The following sub-sections attempt to look into exceptional grounds that may justify the rejection of payment requests of demand guarantees by banks and/or issuance of injunction order by courts, the content and scope of such exceptions and the limits to such exceptions.

### C. Fraud Exception

The idea of conceding fraud as an exception to the principle of independence emanates from the need to protect the basic principle of law regarding equity and justice.<sup>95</sup> It is intended to limit the activities of fraudsters.<sup>96</sup> The assumption is while the autonomous character of the guarantee is intended to ensure the certainty of payment to the beneficiary; it should not override the principle of equity.<sup>97</sup> Hence, courts and guaranteeing banks should be allowed to decline payment of demand guarantee when the existence of fraud is proved. Nonetheless, opinions are

<sup>87</sup> Meyer-Reuman, *supra* note 9, at.33.

<sup>88</sup> *Id.*

<sup>89</sup> Werner Blau & Joachim Jedzig, *Bank Guarantee to Pay upon First Written Demand in German Courts*, 23(3) AMERICAN BAR ASSOCIATION 725, 726 (1986).

<sup>90</sup> Interview with Berhanu Beyene, Director Legal Services Directorate, Zemen Bank S.C (Addis Ababa, Ethiopia, 23 August 2021).

<sup>91</sup> *Id.*

<sup>92</sup> Berhanu, *supra* note 86.

<sup>93</sup> *Id.*

<sup>94</sup> Meyer-Reuman, *supra* note 9, at.38.

<sup>95</sup> *Id.*

<sup>96</sup> Gao Xiang and Ross P. Buckley, *A comparative Analysis of the Standard of Fraud Required Under the Fraud Rule in Letter of Credit Law*, 13(2) DUKE JOURNAL OF COMPARATIVE & INTERNATIONAL LAW 293, 293 (2003).

<sup>97</sup> *Id.*

divided concerning the standard to be applied to define the exact nature and scope of fraud. Some argue that only blatant and apparent fraud should be admitted while others propose a more flexible approach thereby admitting negligent fraud as an exception.<sup>98</sup>

Fraud is defined as “A knowing misrepresentation of the truth or concealment of a material fact to induce another to act to his or her detriment.”<sup>99</sup> Here, the element of intention is emphasized as distinguished from negligence.<sup>100</sup> In a much similar way, fraud is described as any deliberate misrepresentation of the truth of fact to gain something.<sup>101</sup> In this context, mere error, misunderstanding or oversight will not be considered fraud.<sup>102</sup> Hence, the party invoking fraud is expected to show that the beneficiary is intentionally misrepresenting facts to gain undue advantage. From this, it appears that the intentional misrepresentation of facts is required to prove fraud.<sup>103</sup> For instance, in an international sales contract, the intentional failure of the seller to ship goods ordered under the main contract would constitute fraud.<sup>104</sup> Hence, a beneficiary (seller in the above case) who, despite a gross breach of the underlying obligation, calls for payment of demand guarantee may be stopped on account of fraud. It has been said that a beneficiary that has issued a certificate of completion should be stopped on account of fraud if it, at a later stage, resorted to calling guarantee for delayed work.<sup>105</sup> This standard requires proof of ‘intention element’ before an action of the beneficiary is labeled as ‘fraud’.

Some other writers have, however, opted for a more flexible approach. It has been maintained that, as far as misrepresentation of facts is proved, call of payment of demand guarantee can be declined.<sup>106</sup> This is because the beneficiary has failed as effectively as in the case of intentional fraud.<sup>107</sup> Despite the absence of intention, if facts of the case exhibit fraud, courts should stop payment upon application of the principal or the issuer bank.<sup>108</sup> This view is, however, largely contested by other commentators for it invites extensive interpretation of the concept of fraud thereby affecting the relevance of demand guarantees.<sup>109</sup>

Apart from misrepresentation of facts, abuse of the rights emanating from the guarantee is described as fraud.<sup>110</sup> Abuse of right refers to an unwarranted call made for reasons other than those agreed upon by the principal.<sup>111</sup> For instance, a guarantee that has been given in respect of a certain contract cannot be called to satisfy a claim under other legal relations. Abuse of right is

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<sup>98</sup> *Id.*, at.294.

<sup>99</sup> BLACK’S LAW DICTIONARY 1950 (8<sup>th</sup> ed. 2004).

<sup>100</sup> *Id.*

<sup>101</sup> Kelly –Louw, *supra* note 1, p.228.

<sup>102</sup> *Id.*

<sup>103</sup> Xiang & Buckley, *supra* note 96, at. 294.

<sup>104</sup> *Id.*

<sup>105</sup> Blau and Jedzig, *supra* note 89, at.728.

<sup>106</sup> *Id.*

<sup>107</sup> Xiang & Buckley, *supra* note 96, at. 296.

<sup>108</sup> *Id.*

<sup>109</sup> *Id.*

<sup>110</sup> Boris Kozolychyk, *Bank Guarantees and Letter of Credit: Time for a return to the fold*, 11(1) UNIVERSITY OF PENNSYLVANIA JOURNAL OF BUSINESS LAW 1, 39(1989).

<sup>111</sup> *Id.*, at.40

determined based on the nature and scope of the rights acquired under the letter of guarantee.<sup>112</sup> It has to do with a lack of actual entitlement to draw as determined by the demand guarantee.<sup>113</sup> This can be two-fold i.e. the purpose and the qualifying events.<sup>114</sup> In terms of purpose, a guarantee given in respect of a certain contract cannot be called to address claims under other separate different contracts.<sup>115</sup> On the other hand, qualifying events are related to terms indicated under the demand guarantee itself.<sup>116</sup> For instance, most demand guarantees are time-bound and issued to secure a fixed amount of money. Therefore, any call of guarantee after the expiry of the validity period or beyond the secured amount shall be made in vain.<sup>117</sup> Some have, however, questioned if ‘abuse of right’ is to be raised in the context of an exception against the principle of autonomy.<sup>118</sup> Following the contractual relationship between the bank and beneficiary, which is created by virtue of guarantee letter, abuse of right emanating from the guarantee can be defended, more convincingly, on account of contractual relationship rather than fraud as an exception.<sup>119</sup> This is because abuse of right under the guarantee is strictly attached to the guarantee itself and defences are related to lack of entitlements to draw under the guarantee unlike fraud exception that operates in relation to underlying contracts or matters unrelated to guarantee itself.<sup>120</sup>

On the other hand, it is important to note that every alleged instances of fraud should not be admitted to avoid payment of demand guarantees. As the principle dictates narrow interpretation of exceptions, the same must be adopted in relation to exceptions proposed against demand guarantees. Hence, to maintain integrity of demand guarantees, a resort to fraud shall be carefully analyzed to establish beneficiary has represented facts of non-performance contrary to truth and there is sufficient evidence to prove such misrepresentations.<sup>121</sup> Demand guarantees prevent impediment of projects/contracts by preserving a security that can be used to keep smooth progression of the project for which the guarantee is given and the principal fails to perform or poorly performs. Therefore, a claim that deviates from this purpose and text of the guarantee shall be scrutinized against possible instance of fraud. Otherwise, extensive interpretation might invite the tendency of considering every alleged fact as fraud thereby reducing the relevance of demand guarantees.

In Ethiopia, owing to the absence of a sufficient normative framework, it may be difficult to determine if ‘fraud’ is an exception to the principle of autonomy. However, it is known that fraud is not a new concept to the Ethiopian laws of contracts. It is a widely recognized concept that is usually raised and discussed concerning the vitiation of consent. Thus, fraud as an exception to

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<sup>112</sup>Meyer-Reuman, *supra* note 9, at.31.

<sup>113</sup> Boris, *supra* note 110, at.41.

<sup>114</sup> Meyer-Reuman, *supra* note 9, at.31.

<sup>115</sup>*Id.*

<sup>116</sup>*Id.*

<sup>117</sup>*Id.*

<sup>118</sup>Boris, *supra* note 110, at.38.

<sup>119</sup>*Id.*

<sup>120</sup>*Id.*

<sup>121</sup>Michelle Kelly –Louw, Limiting Exceptions to the autonomy principle of demand guarantee and Letter of Credit, in Essay in Honor of Frans Malan214, 197-218 (Coenraad Visser ed., 2014).

the autonomy principle can be assessed having regard to the applicable provision of the law of contract.

Under Ethiopian law of contract, fraud, which refers to deceitful practices<sup>122</sup>, is a ground for invalidation of a contract.<sup>123</sup> If proved, a contract affected by deceitful practices and misrepresentation of facts can be invalidated.<sup>124</sup> As described by Rene David, deceitful practice is a false statement accompanied by a practice that intends to buy an undue advantage to the contracting party.<sup>125</sup> It represents any form of misrepresentation of fact which, if known to the other party, would have aborted the making of the contract. In this case, the party who is affected by such a fraudulent act may require invalidation of the contract.

Then, the question is if such provisions of general contract can be invoked in stopping unscrupulous beneficiary from unduly confiscating demand guarantees. In fact, in demand guarantees, the effect of the fraudulent activity may not lead to invalidation of the demand guarantee. It is rather supposed to restrain trickery call of demand guarantees that is based on deception of existing realities related to conditions and terms upon which the guarantee is given.<sup>126</sup> As such, it can be maintained that the principle that operates to stop contracts tainted by deceitful acts may equally apply to restrain unscrupulous call of demand guarantee. From the perspective of the law of contracts, the prohibition of fraud is intended to ensure the pure will and consent of the contracting parties. However, apart from serving the purpose of invalidating contracts affected by the deceitful practice, the concept of fraud is introduced with the general purpose of curbing undesired behaviors related to cheating.<sup>127</sup> Because of this, it can be argued that a beneficiary that deceitfully seeks to confiscate demand guarantee can be stopped on account of fraud. The idea is an analogical interpretation of Article 1704 that can be employed to restrain a call of demand guarantee that is based on deceitful practices. In the absence of explicit rules, based on the similarity of facts involved, an analogical interpretation of existing law can be used to fill legal gaps.<sup>128</sup>

The action of the fraudulent beneficiary that aims to confiscate demand guarantee based on false information is the same as the act of a contracting party that intentionally presents non-existing facts to land a contract that would have not been concluded otherwise. Furthermore, no law encourages undue advantage from the misrepresentation of real facts. Needless to mention, a normally operating legal system stands out against any form of action that goes contrary to truth. Thus, as long as the call of demand guarantee is proved to have been based on false information; restraining order must be issued to withhold payment of the sum of demand guarantees.

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<sup>122</sup>CIVIL CODE OF THE EMPIRE OF ETHIOPIA, Proclamation No. 165/1960, NEGARIT GAZETA, 19<sup>th</sup> Year No.2, 5<sup>th</sup> May 1960, Addis Ababa [here after], Art. 1704.

<sup>123</sup>*Id.*

<sup>124</sup>KRZYZUNOWICH, *supra* note 76, at.54.

<sup>125</sup>RENE DAVID, COMMENTARY ON ETHIOPIAN LAW OF CONTRACTS, (Faculty of Law, Haile Sillassie I University) (1973), at.25.

<sup>126</sup>Xiang & Buckley, *supra* note 96, at. 50.

<sup>127</sup>KRZYZUNOWICH, *supra* note 76, at.54.

<sup>128</sup>Imre Zajtay, *Reasoning by Analogy as Method of Law Interpretation*, 13(3) THE COMPARATIVE LAW JOURNAL OF SOUTHERN AFRICA 324, 326(1980).

Even though direct reference to fraud exception is not made, a certain court decision has authorized the guarantor's refusal to honor guarantee payment request on account of beneficiary's misuse of its right under the guarantee instrument.<sup>129</sup> The court freed the guarantor off liability since the beneficiary willfully diverted proceeds of export, for which the guarantee letter is issued, to unrelated debts.<sup>130</sup> The beneficiary could have used the sum of export for settlement of the sum guaranteed, which is, however, used for unrelated claims hoping to dwell on the guarantee.<sup>131</sup> It has been, therefore, concluded that the beneficiary has resorted to fraud, which authorizes the guarantor to decline payment.<sup>132</sup>

#### D. Illegality as Exception to the Principle of Autonomy

In terms of general principles of the Ethiopian law of contract, obligations which are contrary to the law are considered illegal.<sup>133</sup> This means that contracts in violation of the law will not be enforceable.

In line with the issue at hand, demand guarantee transactions that are partly or entirely affected by legal wrong are not enforceable. However, as demand guarantee involves at least two transactions, *i.e.* the underlying contract and demand guarantee instrument, it is important to identify if the stated illegality is being referred to either of the two or both. It is maintained that the illegality of the guarantee instrument shall not be raised in the context of exception to the principle of autonomy.<sup>134</sup> If illegality of the guarantee letter is to be invoked, it would be on account of the contractual relationship between the beneficiary and the bank and not as an exception to the principle of independence which operates in matters that are exterior to demand guarantee.<sup>135</sup> Hence, if an illegality exception is to be raised, it would be concerning the underlying contract.

However, whether illegality should be adopted as an independent exception to the principle of autonomy is controversial.<sup>136</sup> The resistance partly emanates from the need to uphold the principle of independence which preserves the interest of the beneficiary. It has, however, been asserted that the policy underlying principle of independence should not be confined to protecting the interest of beneficiary alone.<sup>137</sup> McLaughlin reiterates that when the payment request is made in pursuance of demand guarantee, whose underlying contract is marred with an illegal act, the beneficiary's protection should receive little weight.<sup>138</sup> This is because, at times,

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<sup>129</sup> *Wegagen Bank S.C V. the National Bank of Ethiopia*, FED. SUPREME CT. CASS. BEN.,(2015), (unpublished) as cited in Yared, *supra note* 40, at.56.

<sup>130</sup> *Id.*

<sup>131</sup> *Id.*

<sup>132</sup> *Id.*, at.57.

<sup>133</sup> KRZEUZUNOWICH, *supra note* 76, at.75.

<sup>134</sup> Gerald T. McLaughlin, *Letter of Credit and Illegal Contracts: The Limits of Independence Principle*, 49 (5) OHIO STATE LAW JOURNAL 1197, 1209(1989).

<sup>135</sup> *Id.*

<sup>136</sup> Kelly-Louw, *supra note* 29, at. 341, See also Zhixiong Liao, *Illegality in the underlying Transaction: A defense to Dishonouring Letters of Credit?*4(23) WAIKATO LAW REVIEW 34, 34 (2015) & Kelly-Louw, *supranote* 30, at 386.

<sup>137</sup> McLaughlin, *supra note* 134, at.1218.

<sup>138</sup> *Id.*, at.1228.



admission of payment requests with full knowledge of the criminal nature of the underlying contract might entail the guaranteeing bank criminal liability.<sup>139</sup> For instance, a bank may be held criminally liable for honoring a letter of guarantee issued to secure an underlying contract obtained through bribery.<sup>140</sup> The principle of independence also operates to protect the interest of the bank and the guarantee mechanism itself. Hence, if it is presented with convincing evidence, rejection of payment request is not only legitimate but also in the interest of the bank.<sup>141</sup> The merit of demand guarantee would be severely damaged if illegal underlying contracts are allowed to prevail for want of principle of autonomy. As criminalization of an act is the strongest expression of societal condemnation, in this case, insulating illegal underlying contract from demand guarantee would defy such societal interest.<sup>142</sup> The argument that upholds illegality as an exception also relies on certain legal maxims including, for instance, “no person may benefit from his own wrong” and ‘no cause of action may be founded on an illegal act’.<sup>143</sup> It has been also asserted the defense of illegality advances the integrity of the judicial system if courts discourage the conduct of illegality related to underlying contracts.<sup>144</sup> Due to these factors, there are growing views that illegality should be adopted as a second exception to the principle of autonomy.<sup>145</sup>

Besides, under some multilateral agreements, the illegality of the underlying contract is conceded as an exception to the principle of autonomy.<sup>146</sup> For instance, under article 19 of the United Nations Convention on Independent Guarantees and Standby Letters of Credit (UNICTRAL Convention), it is provided that where payment request has no conceivable basis, the guarantee issuing bank has the right to withhold the payment. The payment request is said to have no conceivable basis when the underlying obligation of the principal/applicant has been declared invalid by a court or tribunal.<sup>147</sup> Furthermore, the convention provides an opportunity to solicit and secure provisional injunction order from court whenever there are strong pieces of evidence that suggest the letter is used for a criminal purpose.<sup>148</sup> The binding nature of the above convention is indeed questionable. Such provisions are, nevertheless, an indication as to the fact that illegality of the underlying contract is known to the legal regime of demand guarantees as an exception to the principle of independence.

On the other hand, it has been underscored that before illegality is admitted as an exception, it has to be known and established.<sup>149</sup> This is crucial in maintaining the integrity of demand

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<sup>139</sup> *Id.*

<sup>140</sup> *Id.*, at.1231.

<sup>141</sup> *Id.*

<sup>142</sup> *Id.*

<sup>143</sup> Jason Chuah, *Documentary Credits and illegality in the Underlying Transaction*, 9(6) JOURNAL OF INTERNATIONAL MARITIME LAW 518, 519(2003).

<sup>144</sup> *Id.*

<sup>145</sup> McLaughlin, *supra note* 134, at.1235, See also Nelson Enonchong, *The Autonomy Principle of Letter of Credit: An Illegality Exception?* Issue 3 LLOYD’S MARITIME AND COMMERCIAL LAW QUARTERLY 404, 34 (2006).

<sup>146</sup> United Nations Convention on Independent Guarantees and Standby Letter of Credit, Dec. 11, 1995, 38030 U.N.T.S, 2169, Art. 19(2) (b) [herein after Convention on Independent Guarantees].

<sup>147</sup> *Id.*

<sup>148</sup> *Id.*, Art. 20(3).

<sup>149</sup> Kelly –Louw, *supra note* 4, at.380.

guarantees as it prevents unsubstantial allegations of illegality. Therefore, mere suspicion of illegality is not enough and the evidence has to be authoritative.<sup>150</sup> It is only in proper circumstances that an underlying contract marred with illegality should relieve the guarantee issuer from its obligation to pay demand guarantees.<sup>151</sup>

Under the Ethiopian law of contract, the existence of illegality is one of the fundamental grounds that may cause invalidation of a contract.<sup>152</sup> With this, we may raise a question as to whether we apply the concept of illegality to decline payment of demand guarantees issued on account of illegal underlying contracts. Given the jurisprudential dearth on the subject, there can be no straightforward answer to this. However, Articles 1716(1) and 1815(2) of the Civil Code make it clear that obligation of the parties marred with illegality shall produce no effect. Based on this, it can be argued that actions based on such an unlawful contract shall also be of no effect. To illustrate with an example, a demand guarantee issued to ensure the delivery of illicit drugs may be challenged on account of illegality. Therefore, the underlying contract with an unlawful object, such as a prohibited drug, is deemed to be illegal. It then follows that the principle of autonomy does not operate to allow confiscation of a guarantee given on account of underlying contract affected with illegality.

## VI. CONCLUSION

In Ethiopia, demand guarantees constitute an important aspect of the banking business. However, the absence of a comprehensive and explicit legal framework has invited uncertainties concerning the rights and obligations of parties involved. This is particularly true as regards the extent of the right of the beneficiary against the issuing bank. The doctrine of autonomy suggests that beneficiaries should be paid on demand. However, vigorous misuse of such rights has brought into scene exceptions that might block on sight payment. On the other hand, to uphold the unconditional nature of demand guarantees, it is important to restrict these exceptions. As a result, this Article has attempted to find a middle ground between the obligation to pay on demand and the extent to which exceptions should be allowed. While it does not offer a conclusive answer, it dealt with the nature of such exceptions, why and how it should be entertained in declining payment of the guarantee. The paper has also proposed the exceptions to principle of autonomy should be narrowly interpreted to curb extensive understanding that might threaten the relevance of demand guarantees.

Accordingly, it has been argued that the involvement of established fraud and illegality should be admitted as an exception to payment of demand guarantees. In Ethiopia, there might be no explicit legal basis that provide for admission of fraud and illegality as an exception to principle of autonomy. However, purposive and analogical interpretations of provisions of the Civil Code dictate the need to adopt the exceptions. The principle of good faith and legality of transactions, which are well known in Ethiopia, constitute another reason to defy callings of demand guarantees taunted with fraud and illegality. Therefore, during unfair calling, banks with

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<sup>150</sup>*Id.*, at.366.

<sup>151</sup>McLaughlin, *supra note* 134, at.1217.

<sup>152</sup>Civil CODE, *supra note* 122, Art. 1716(1) & (2).

sufficient evidence as to fraud and illegality are advised to withhold payment requests. On the other hand, the principal might have to apply to court for issuance of the injunction that stops payment. Yet, in this case, courts are required to adopt strict scrutiny of grounds upon which stoppage of payments was requested. Furthermore, necessary caution should be taken to avoid the admission of every allegation as instance of fraud and illegality. To this end, narrow interpretation of the terms should be pursued. While this deals with unfair callings of demand guarantees it, on the other hand, maintains the integrity of demand guarantees.

Finally, in the face of extensive usage of demand guarantees, inadequate regulation may severely affect certainty and predictability in their issuance and operation. This indeed hampers the development of guarantee business, which plays a crucial role in the smooth functioning of a business transaction. Hence, until a prudent legal regime is designed and put in place, admission or rejection of call of demand guarantees must be addressed under explicit provisions of the guarantee, relevant provisions of the Civil Code, the principle of contracts, and case law to the extent applicable.

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