
Overview of a Demand Guarantee and Practical Points of Attention When Requesting Payment

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[Contents]

1. Background
2. Overview of a Demand Guarantee
 - (1) The difference with the guarantee under the Civil Code of Japan
 - (2) The functions of a Demand Guarantee
3. Practical Points of Attention When Request Payment based on a Demand Guarantee
 - (1) The risk of a provisional disposition based on the defense of abuse of right
 - (2) The risk of refusal of payment by the guarantor

1. Background

A demand guarantee ("**Demand Guarantee**") is a letter of guarantee issued to one of the parties (beneficiary) for the purpose of securing the default of the counterparty (consignor) in a certain transaction and an undertaking to make payment to the beneficiary in response to presentation of documents explicitly described in the Demand Guarantee, regardless of the underlying contract *1.

Demand Guarantees are widely used in, among other things, international construction projects and long-term supply contracts with overseas contractors.

As an international framework, the Uniform Rules for Demand Guarantees were established by the International Chamber of Commerce in 1992 as uniform rules for Demand Guarantees that match the actual circumstances of transactions.

In response to this, in Japan, the Tentative Draft of Agreement on Demand Guarantee Transactions was prepared by the Japanese Bankers Association in 1994 *2.

*1: Demand Guarantee is defined as "the undertaking providing for payment to the beneficiary, based on the consignor's request and for the consignor's own account, on the condition of presentation of the payment request and other documents complying with certain requirements regardless of the underlying contract and not bound by the underlying contract" in Article 1 of the Tentative Draft of Agreement on Demand Guarantee Transactions. Demand Guarantees are also called by various other names such as "On-Demand Guarantee", "On-Demand Bond", "Performance Bond", "Performance Guarantee", "Bank Guarantee" or "Corporate Guarantee", but it is necessary to interpret whether they actually constitute Demand Guarantees by considering their substance.

*2: As to the provisions of this draft, please refer to 1395, Junkan Kinyū hōmu jijō, at 41 (1994).

As mentioned above, a Demand Guarantee is often used for international projects, etc., but so far, in Japanese domestic transactions, Demand Guarantees have only been used to a limited extent such as in public construction projects. However, there are a considerable number of cases in which a Demand Guarantee is issued. In fact, our law firm has handled several cases related to Demand Guarantees recently. For example, we handled a notable case where a Demand Guarantee worked in the sense that the beneficiary received payment from the guarantor related to damages caused by delays in an overseas project due to the Covid-19 pandemic.

There are scant judicial precedents regarding Demand Guarantees in Japan, the only published judicial precedent in which the interpretation of a Demand Guarantee was directly at issue is: Ōsaka Kōtō Saibansho [Ōsaka High. Ct.] Feb 26, 1999, Hei 10 (ne) no. 128, 1068 KIN'YŪ SHŌJI HANREI [KINHAN] 45 (Japan) and Kōbe Chihō Saibansyo [Kōbe Dist. Ct.] Nov 10, 1997, Hei 6 (wa) no. 1626, 984 HANREI TIMES [HANTA] 191 (Japan) *3.

*3: In this case our law firm represented the beneficiary and claimed against the bank, which issued a letter of guarantee as to the obligation of the Japanese shipbuilding company under the shipbuilding contract between the beneficiary and such company, to perform the guarantee obligation to pay the same amount of advance fee, which was within the limit set forth in the letter of guarantee (which was governed by English law). Whether the letter of guarantee constituted a Demand Guarantee became an issue in this case, and the Japanese court concluded that the letter of guarantee was a Demand Guarantee because of the sentence which indicated the on-demand nature of the guarantee (the payment obligation upon a demand complying with certain minimal requirements) in the letter and English judicial precedents, etc.

2. Overview of a Demand Guarantee

(1) The difference with the guarantee under the Civil Code of Japan

The difference between a Demand Guarantee and the guarantee under Article 446 of the Civil Code of Japan is whether it has collaterality (*fujūsei*) against the principal obligation or not.

That is, even if the obligee demands the guarantor to perform the guarantee obligation, the guarantor may assert a defense which the principal obligor may assert against the obligee as a defense against the obligee (Civil Code of Japan, Article 457, Para. 2).

On the other hand, the guarantor of a Demand Guarantee may not assert a defense which the consignor may assert against the beneficiary in relation to the underlying contract as a defense against the beneficiary. That is, the guarantor is obliged to pay to the beneficiary the amount specified in the letter of guarantee, irrespective of whether or not there is a default under the underlying contract as long as the claim by the beneficiary satisfies the requirements set forth in the Demand Guarantee.

As to such nature of a Demand Guarantee, there have been cases where overseas companies which make deals with Japanese companies are concerned about the effect of a Demand Guarantee which a Japanese bank issues as the guarantor under Japanese law. However, a Demand Guarantee is considered legally valid based on the principle of freedom of contract because it serves the functions described in item (2) below and has substantial reasonableness *4. Having said that even if its general validity is recognized, it is necessary to carefully consider the interpretation of the Demand Guarantee based on its actual language because the applicability of the Demand Guarantee to a specific case largely depends on the specific language used in the specific Demand Guarantee. If you would like to clarify whether or not a specific obligation constitutes a Demand Guarantee under Japanese law, it would be advisable to consider obtaining a legal opinion from an expert in Japanese law.

*4: Kenjiro Egashira, *Seikyūbarai Muin Hoshō Torihiki no Houteki Seishitsu [Legal Nature of Demand Guarantee Transactions]*, 1395, Junkan Kinyū hōmu jijō, at 7 (1994).

(2) The functions of a Demand Guarantee

A Demand Guarantee has the following functions *5:

- (i). The beneficiary may receive payment from the guarantor immediately if the beneficiary submits the documents satisfying the requirements set forth in the letter of guarantee, even if there is a dispute between the beneficiary and the consignor regarding the existence of the obligation under the underlying contract; and
- (ii). The guarantor may make payment to the beneficiary only by confirming whether the submitted documents satisfy the requirements set forth in the letter of guarantee and request reimbursement from the consignor of the amount the guarantor paid, irrespective of the existence of an obligation under the underlying contract. Therefore, the guarantor may avoid a dispute regarding the underlying contract. A dispute regarding the underlying contract is resolved through a lawsuit between the consignor and the beneficiary, etc.

*5: Egashira, supra note 4, at 7.

3. Practical Points of Attention When Request Payment based on a Demand Guarantee

(1) The risk of a provisional disposition based on the defense of abuse of right

As noted above, the guarantor is obligated to pay to the beneficiary the amount specified in the letter of guarantee as long as the claim by the beneficiary satisfies the requirements set forth in the letter of guarantee.

However, there is high possibility that a Japanese court would determine that the guarantor may refuse the payment as an abuse of right by the beneficiary under the following circumstances (the so-called “defense of abuse of right” *6):

- (i). If the guarantor of the Demand Guarantee asserts facts proving unambiguously the absence of any obligation under the underlying contract, etc., that it is uncontestable as a matter of law;
- (ii). There is conclusive evidence in the possession of the guarantor proving that the facts are as asserted by the guarantor; and
- (iii). The facts are of such importance as rarely occurs in the ordinary course of transactions.

*6: Egashira, supra note 4, at 9.

It is interpreted that there is an obligation (Civil Code of Japan, Article 644) of the guarantor to refuse the claim of the beneficiary by asserting such defense in case such defense is established and the consignor may file a petition for a provisional disposition order to prohibit payment in order to suspend the payment of the guarantor *7.

Therefore, for the beneficiary, it is necessary to note whether there is the possibility that the defense of abuse of right can be established, such as whether it is clear that the obligation under the underlying contract does not exist when the beneficiary considers making a claim based on the Demand Guarantee.

*7: Egashira, supra note 4, at 9.

(2) The risk of refusal of payment by the guarantor

It may also be possible that the guarantor refuses payment because of a discrepancy in the required documents in case that the guarantor reviews the submitted documents and finds a discrepancy between the documents and the Demand Guarantee.

Therefore, it is very important for a beneficiary who considers making a claim based on the Demand Guarantee that the submitted documents strictly satisfy the requirements set forth in the Demand Guarantee. It should be noted that the beneficiary should carefully review whether the requirements set forth in the Demand Guarantee are satisfied including any minor difference in language when making a claim under the Demand Guarantee.

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