

# LEGAL ASPECTS OF A BANK GUARANTEE AS A FINANCIAL SECURITY INSTRUMENT

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## *Abstract*

*A bank guarantee is an important instrument for securing financial obligations in legal transactions, creating security and trust between the contracting parties. This paper analyzes the legal aspects of a bank guarantee as a security interest, including its legal nature, types of guarantees, as well as the rights and obligations of the contracting parties. Special focus is placed on the analysis of domestic legislation in the Republic of Serbia and comparative legal practice, highlighting the similarities and differences of approaches across different jurisdictions. The paper also examines the role of bank guarantees in international transactions with reference to relevant international conventions and regulations, especially in the context of globalization of markets. The aim of the paper is to provide a comprehensive overview of the legal framework that governs the issuance and enforcement of bank guarantees and to identify challenges and opportunities for improving this financial instrument in practice. Based on the analysis, recommendations are made for legal entities to optimize the use of bank guarantees in business transactions.*

**Keywords:** *bank guarantee, legal aspects, financial security, international transactions, Serbian legislation, legal framework, legal certainty, comparative law.*

## **Introduction**

A bank guarantee is a financial instrument that plays a crucial role in modern business, offering an additional layer of security in contractual relations between business entities(Jović Bogdanović et al., 2024). It helps mitigate the risk of default in legal transactions, particularly in the context of complex and high-value contracts, such as those in the construction industry, international trade, and the financial sector. A bank guarantee fosters trust between parties, enabling business transactions to proceed smoothly even in environments with significant uncertainty or risk.

The use of bank guarantees is especially prominent in international business arrangements, where legal and cultural differences between countries can significantly challenge the enforcement of contractual rights(Srbulović et al., 2024). In these situations, a bank guarantee serves as a universally recognized and accepted security instrument across various legal systems. This type of guarantee

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provides the contracting parties with confidence in the fulfillment of contractual obligations, even when dealing with partners from different jurisdictions.

The aim of this paper is to provide a detailed analysis of the legal aspects of bank guarantees as a means of security, with a particular focus on the legislation of the Republic of Serbia. The analysis will also consider comparative legal perspectives by examining how other legal systems address this financial instrument, highlighting both similarities and differences in regulation. Additionally, the paper will explore international standards and conventions governing the issuance and implementation of bank guarantees, which is crucial in today's globalized market.

The methodology of this paper involves an analysis of relevant legal sources, including laws, bylaws, international conventions, and professional literature. By comparing Serbian practices with those of other jurisdictions, the study aims to identify best practices and potential solutions for addressing challenges in the implementation of bank guarantees within the Serbian legal framework.

This paper provides a comprehensive overview of bank guarantees, including their legal nature, types, Serbian legal framework, and international comparisons. Ultimately, it aims to offer practical guidance for Serbian legal entities on effectively utilizing bank guarantees to enhance legal certainty and mitigate transaction risks.

### **Legal Nature of a Bank Guarantee**

A bank guarantee is a legal instrument through which a bank undertakes the obligation to pay a specific amount of money to the beneficiary, upon the beneficiary's request, if the debtor fails to fulfill its obligations under the contract. A bank guarantee is considered one of the most reliable security instruments because it allows the beneficiary to collect its claims regardless of any potential disputes with the debtor (Jovanović, 2017; Janošik et al., 2023).

The autonomy of a bank guarantee is a key distinguishing feature. Unlike other security instruments, it is independent of the underlying contract between the debtor and the beneficiary. This means the beneficiary can claim payment regardless of disputes or issues with the original contract (Stojanović, 2015). This principle is essential for legal certainty but requires careful drafting of contractual terms.

Unlike mortgages and pledges, which are tied to specific assets, bank guarantees are personal securities that do not require possession or control of property.

Additionally, unlike warranties, bank guarantees are completely independent of the debtor, making them more effective collateral for international transactions (Knežević & Lukić, 2016; Petrović, 2019).

## **Types of Bank Guarantees**

Bank guarantees can be either revocable, which means the bank can withdraw them at any time, or irrevocable, which means they are binding until the expiry date or the payment date. Irrevocable guarantees are much more common in practice due to the higher level of legal certainty they provide to beneficiaries (Petrović, 2019).

Based on their purpose, bank guarantees can be classified into payment guarantees, performance bonds, bid bonds, and advance payment guarantees. Each of these guarantee types has a specific role in securing different aspects of contractual obligations, making them adaptable to various business situations (Jovanović, 2017; Knežević & Lukić, 2016).

Bank guarantees can be conditional, where the beneficiary must prove the non-performance of the obligation before payment, or unconditional, where the bank pays upon the first demand regardless of the validity of the claim. Unconditional guarantees provide the highest level of protection for the beneficiary but carry a higher risk for the bank (Stojanović, 2015).

## **Legal framework in the Republic of Serbia**

The legislative framework of Serbia, including the Law of Contract and Torts, the Law on Banks, and the Law on Public Procurement, provides a robust foundation for regulating bank guarantees. These laws clearly outline the rights and obligations of all parties involved, establishing standards for the issuance and implementation of bank guarantees (Knezevic & Lukic, 2016; Marković, 2018).

The Law of Contract and Torts defines a bank guarantee as a unilateral legal transaction, where the bank assumes an obligation to the beneficiary of the guarantee. The principle of autonomy of the bank guarantee, prescribed by this law, ensures the independence of the bank guarantee from the underlying contract, providing greater legal certainty to the beneficiary (Petrović, 2019; Gojković et al., 2023).

The beneficiary has the right to claim the specified amount under the guarantee, while the bank is obliged to pay according to the guarantee's terms. The debtor, who requested the guarantee, is responsible for reimbursing the bank for issuance and payment costs (Jovanović, 2017; Pan et al., 2019).

## **Comparative Legal Analysis**

In international transactions, bank guarantees serve as a security instrument that ensures the fulfillment of contractual obligations across various legal and cultural environments. International organizations, such as the International Chamber of Commerce (ICC), have established standards for issuing and executing bank guarantees, which are widely accepted in numerous jurisdictions (ICC, 2010).

**Germany:** Bank guarantees are autonomous and unconditional, providing a high level of security for beneficiaries. Banks must carefully assess risks before issuing a guarantee (Schmidt, 2017).

**United States:** The Uniform Commercial Code (UCC) governs standby letters of credit, similar to bank guarantees. Banks are obliged to make payment upon first demand, but US courts may refuse payment in cases of fraud (Petrović, 2019).

**United Kingdom:** Bank guarantees are binding and independent contracts. British courts interpret the terms of the guarantee strictly, providing a high level of protection for banks (Jovanović, 2017).

The United Nations Convention on Independent Guarantees and Stand-by Letters of Credit sets out basic rules for issuing and executing bank guarantees in international transactions, aiming to ensure legal certainty and predictability (UNCITRAL, 1995). URDG Rules provide detailed rules and guidelines for issuing and executing guarantees in international transactions (ICC, 2010).

### **Challenges and Risks in the Application of Bank Guarantees**

The application of bank guarantees carries a number of legal and financial risks that can significantly impact the parties to a contract. One of the most common legal risks is the abuse of rights by the beneficiary of the guarantee, especially in the case of unconditional guarantees. In these situations, the beneficiary may claim payment from the bank regardless of the actual fulfillment of obligations by the debtor, which can lead to the unjust enrichment of the beneficiary at the expense of the debtor and the bank (Jovanović, 2017; Petrović, 2019).

Financial risks are a major concern in using bank guarantees. Banks issuing guarantees assume the obligation to pay, which can be financially burdensome if the guarantee is triggered. Therefore, banks must carefully assess the borrower's creditworthiness and require adequate collateral or reserves before issuing a guarantee. Failing to do so could jeopardize the bank's liquidity and reputation if it cannot fulfill its payment obligations (Knežević & Lukić, 2016).

The validity of a bank guarantee depends on several factors that must be carefully considered during its issuance. First, the guarantee must be issued in accordance with the law and meet all formal requirements prescribed by the contract and relevant legislation. This includes the precise formulation of the terms under which payment will be made, the validity period of the guarantee, and the identification of all parties to the contract (Nikolić, 2016; Paspalj et al., 2024).

Another key factor that affects the validity of a guarantee is the clarity and precision of the contractual provisions. Insufficiently clear or vague terms and conditions may lead to ambiguity regarding the rights of the beneficiary and the obligations of the bank, which may result in legal disputes and challenge the guarantee. In addition, vaguely defined conditions can lead to situations where the

bank refuses to pay, even when all material conditions are met, due to technical or formal deficiencies (Petrović, 2019; Salum et al., 2019).

The third factor is compliance with the procedure for activating the guarantee. The beneficiary must submit a request for payment in accordance with the procedures and deadlines specified in the contract. Failure to comply with these procedures may result in the bank refusing to pay, potentially leading to the loss of the right to collect on the guarantee. These procedures typically include the submission of evidence of the debtor's default, as well as adherence to all relevant legal deadlines. (Stojanović, 2015; Dašić et al., 2023).

Legal disputes involving bank guarantees often center on whether the payment conditions are met and if the beneficiary acts in good faith. Serbian courts, like many others, frequently rule in favor of the beneficiary if the formal payment requirements are fulfilled. This underscores the importance of carefully drafting contractual provisions and considering all aspects of the guarantee before issuance (Đorđević, 2020).

However, case law also demonstrates that courts may reject payment claims if there is clear evidence of abuse or if the payment conditions are unclear or incomplete. These cases emphasize the importance of carefully drafting contracts and issuing guarantees to avoid legal disputes and ensure legal certainty for all parties (Marković, 2018; Krstić & Brajković, 2022).

In addition, courts often consider the issue of proportionality in cases where the right to payment of a guarantee is contested. For example, when payment of the full guarantee amount is demanded for a relatively minor breach by the debtor, courts may choose to reduce the payment or reject the claim entirely. Such cases demonstrate the courts' efforts to balance the interests of all parties and ensure a fair outcome (Jovanović, 2017; Vladislavljević et al., 2023).

The challenges and risks associated with the implementation of bank guarantees are numerous and necessitate careful legal and financial planning. Legal risks, such as the potential abuse of beneficiaries' rights, as well as financial risks related to the payment of the guarantee, require banks and other transaction participants to implement adequate protection measures. The validity and effectiveness of the guarantee depend on the clarity and precision of the contractual provisions, as well as on adherence to all relevant procedures and deadlines. Judicial practice demonstrates that both formal and substantive conditions are critical for the enforcement of the right to payment, with courts striving to ensure a fair outcome for all parties involved.

In addition to legal and financial risks, the implementation of bank guarantees in Serbia also faces significant regulatory challenges, particularly in the context of harmonization with international standards. For instance, Basel III regulation, which includes capital adequacy requirements and leverage ratios, directly impact

banks' ability to issue guarantees by influencing the level of capital that must be retained to cover potential losses (Basel Committee on Banking Supervision, 2013). Moreover, legal frameworks such as the Capital Requirements Directive (CRD IV) in the European Union impose additional risk management requirements, which can lead to increased costs for banks in Serbia that conduct business with foreign partners (European Banking Authority, 2014).

Regarding alignment with international standards, the United Nations Convention on Independent Guarantees and Stand-by Letters of Credit is particularly important. It provides a framework for the legal protection of beneficiaries of guarantees in international transactions (UNCITRAL, 1995). Moreover, economic research has shown that countries with stable regulatory frameworks and clear legal norms have significantly lower risks of guarantee abuse and greater legal certainty, contributing to a more efficient and attractive business environment (Mülbert, 2015).

### **Recommendations for Improving the Legal Framework and Practice in Serbia**

Bank guarantees are a crucial tool for ensuring the fulfillment of contractual obligations, but the legal framework in Serbia requires certain amendments and improvements to ensure greater legal certainty and efficiency. One of the main aspects that could be improved is a more precise definition of the conditions for issuing and activating bank guarantees, which would reduce legal disputes between banks, debtors, and beneficiaries of the guarantee (Knežević & Lukić, 2016; Milanović, 2023). Additionally, the legislation could introduce clearer guidelines for treating different types of guarantees, including unconditional and conditional guarantees, to enable parties to better understand their rights and obligations (Petrović, 2019).

Standardized contractual provisions for bank guarantees could significantly reduce misunderstandings and legal disputes. Standardization would include defining key terms, outlining activation procedures, and providing clear guidelines for dispute resolution. This would ensure all parties have a shared understanding of the contractual terms and conditions, effectively managing risks (Marković, 2018).

Case law plays a crucial role in interpreting and applying legal norms related to bank guarantees. Serbian courts should consistently apply the principle of guarantee autonomy to enhance legal certainty for beneficiaries (Jovanović, 2017; Li, 2020). Additionally, courts could develop more specific criteria for assessing claims of abuse to prevent unjustified payments and protect the interests of all parties involved.

Greater transparency in issuing and activating bank guarantees can enhance trust in this legal instrument. Public disclosure of basic information about issued

guarantees, including terms and conditions, is recommended. This would increase transparency, reduce the risk of misconduct, and promote legal certainty (Nikolić, 2016; Penjišević et al., 2023)."

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One important aspect of improving the practice of bank guarantees is the continuous education and training of all participants in the process, including lawyers, bankers, and judges. Education could involve specialized seminars and workshops on new legislative developments, best practices for drafting contract terms, and relevant case law concerning bank guarantees (ICC, 2010).

Improving the legal framework and practice regarding bank guarantees in Serbia requires a multidisciplinary approach. This includes legislative changes, standardization of contractual provisions, consistent case law, increased transparency, and ongoing education for all participants. Implementing these measures would significantly enhance legal certainty and the efficiency of this important legal instrument, ultimately leading to better protection of the rights and interests of all parties involved in business transactions.

## **Conclusion**

A bank guarantee is an important instrument for securing financial obligations in legal transactions, creating security and trust between the contracting parties. Its legal nature, based on the principle of autonomy, enables users to protect themselves against the risk of default while imposing an obligation on banks to make payments under specified conditions. In Serbia, the legal framework for bank guarantees is created by laws, including the Law of Contract and Torts the Law on Banks, and the Law on Public Procurement, which collectively provide a solid foundation for their implementation.

A comparative legal analysis shows that different jurisdictions have different approaches to regulating bank guarantees, but all agree on central principles such as the autonomy of the guarantee and the obligation to pay unconditionally. International conventions and standards, such as the URDG rules, make it possible to harmonize these instruments at a global level and reduce the legal risks involved in international transactions.

Although a bank guarantee is an effective and secure instrument, its implementation presents several challenges and risks. While it is crucial to protect the rights of beneficiaries, banks must also take appropriate measures to safeguard themselves against potential abuses and financial losses. Case law indicates that

the clarity of contractual provisions and careful planning are vital for the successful implementation of this instrument.

Looking ahead, it is recommended to further develop the legal framework in Serbia to enhance the legal certainty and efficiency of bank guarantees. Additionally, the practices of banks and other financial institutions should be improved to reduce risks and increase the protection of all parties involved in legal transactions.

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