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Cristina Contreras, Seguros Confianza S.A., Ecuador

Autonomous or accessory nature of performance guarantees

Case analysis

Abstract

The term “on-demand” is frequently used with reference to certain types of guarantees required by government entities. This phrase originates in the international interbank practice, which has indeed introduced guarantee instruments that include conditions favoring the creditor which involve major differences with the traditional forms of guarantees, inheritors of the surety bond tradition. The tension among tradition, the demand for liquid instruments and the public beneficiaries’ interest in improving their credit position outlines the macro scenario for guarantees for government entities.

This work first outlines the elements that define traditional or accessory guarantees and differentiate them from on-demand or autonomous guarantees. It then evaluates the insurance instruments issued by insurance companies in favor of government entities in three countries taking into account the selected variables, in order to identify in these instruments the autonomous and/or accessory nature and, therefore, the level of liquidity carried by the instruments in the three countries studied.

Autonomous or accessory nature of personal guarantees and liquidity level

Surety bonds share credit protection, with all its nuances and peculiarities, with the codified legal systems. In a summary report on a study on secured and personal guarantees prepared on the basis of reports from 15 jurisdictions in America, Europe, Asia and Australia, Ulrich Drobnig comes to the conclusion that the surety bond as “a basic model for personal guarantees seems to be known all over the world and is regulated in all civil law systems” (Drobnig, 2004), which means, at least in all the systems evaluated under that study.

On the other hand, in their comparative law study on secured guarantees Enrico Gabrielli and Carlos de Cores identify two models as regards credit protection: one of them, shared by Spain, Italy and Latin America, includes codification processes based, to a greater or lesser extent, on the French Civil Code; the other was developed from the German law and the common law. For the purpose of this work, any reference made in the rest of this document is to the first model.

In general terms, the intended purpose of guarantees is the effective fulfillment of an obligation. In the case of personal guarantees, a third party other than the debtor assumes the obligation to provide additional support for the fulfillment of the main obligation. The role of personal guarantees is to correct the weak position of unsecured creditors, who, in case of default, are entitled to have recourse against the debtor’s assets but the payment of the debt is subject to the upturns and downturns of these assets. Personal guarantees improve the creditor’s position: although they do not involve an increase in the amount to be received as settlement of the main obligation, they do entail an increase in the probabilities that their original claim be settled.

The main feature that both personal guarantees and surety bonds share is their accessory nature. An accessory contract may be defined as a contract the purpose of which is to guarantee the fulfillment of another contract–the main contract–; hence, this accessory nature has the following effects:

1. Existence: the main contract is deemed to survive on its own, while the accessory contract is subordinated to the existence and effectiveness of the main contract.
2. Scope: the surety's obligation cannot exceed the guaranteed obligation. The guarantor's liability extends no further than the principal debtor's obligation.
3. Defenses. Guarantees are accessory to the contract they are attached to. In order to avoid a guarantee to be called on, the guarantor might raise the defenses derived from the guarantee itself, in addition to those the debtor is entitled to.

Accessory guarantees are linked to the obligation which is the subject matter of the guarantee. While it is clear that guarantees improve the creditors' position by adding other assets to secure their claim, the effects of the accessory nature show that the satisfaction of the credit is subject to the upturns and downturns of both the main contract and the guarantee business. It is also necessary to stress that in accessory guarantees the burden of proving the default, which justifies the call on the guarantee, is borne by the creditors, which further impairs their credit position.

In addition to the accessory nature, surety bonds can grant other benefits to the guarantor, such as subsidiarity, which obliges the creditor to have recourse against the debtor first, and the right of excussio (guarantor's right to demand prior exhaustion of remedies by the creditor against the debtor before proceeding against the guarantor)

Given the weaknesses the previous framework poses for creditors' position, the practice of international commerce and related financial transactions has boosted the development of guarantees which are autonomous or independent from the main contract. The complete severance of the guaranteed obligations contrasts with the accessory nature which is typical of guarantees and with the regulations developed on the basis of their essential elements. This has become a major topic of discussion in the field of legal doctrine in several countries, since the severance of the instrument from the cause is in contradiction to the causality principle: this is why this negotiating structure lacks specific regulation in the countries' legal systems.

In view of the growing importance of autonomous guarantees and with the purpose of standardizing these instruments and providing legal certainty to the parties, the International Chamber of Commerce (ICC) has drawn up the Uniform Rules For Demand Guarantees (URDG). By way of definition of autonomous or independent demand guarantees, we quote Article 5 of the URDG:

> A guarantee is by its nature independent of the underlying relationship and the application, and the guarantor is in no way concerned with or bound by such relationship. A reference in the guarantee to the underlying relationship for the purpose of identifying it does not change the independent nature of the guarantee. The undertaking of a guarantor to pay under the guarantee is not subject to claims or defences arising from any relationship other than a relationship between the guarantor and the beneficiary. (ICC, 2010)

In strict sense, guarantees that fit the above definition are called on-demand guarantees, since there is no condition for payment other than the call on the guarantee

We find, then, that there are two ways of viewing guarantees: on the one side, there is the legal tradition, which applies the accessory nature and on the other side, the commercial practice, which increasingly favors the use of independent guarantees for secured contracts. The definitions provided in this study clearly show that autonomous guarantees offer greater security to the creditors' claim, since they are relieved from the burden of proof in the case of default and shall only be subject to the defenses arising from the guarantee contract.

Public interest

The guarantee instruments issued by insurers, surety companies and financial institutions have evolved in line with commercial needs and the regulations in force in the countries of domicile of the parties involved. However, in the case of public beneficiaries, there is a common element which is of utmost importance for guarantee instruments: the existence of the State´s discretionary powers. In general terms, the contracts entered into between the public administration and public or private parties are governed by the administrative law. The priority of common good breaks the equilibrium in contract relationships and justifies prerogatives that favor the public entity, with no other option left to the private party than complying with them . This excessive disparity provided by the system for the benefit of the public administration may result in certain acts derived from the wishes of the administration and not from the mutual agreement of the parties.

From the perspective of the beneficiary, the purpose of insurance is to grant certainty of the debtor's performance or, failing this, that there will be compensation from the guarantor (Pérez Calvo, 2013). According to this approach, it would make sense that, in the exercise of the above mentioned prerogatives granted by administrative law, government entities sought to correct those features of accessory guaranties that impair the position of the government entity as a creditor. In other words, government entities should be expected to regulate guarantee instruments that ensure them a smooth and prompt settlement of their credit, that is to say, instruments which cannot be reached by the guarantor's defenses and objections to payment and which do not place the burden of proof on the contracting entity.

Practical implications – Guarantees for government entities

The elements introduced up to now can be defined as influence variables which are essential for guarantees given to government entities at present. In summary, we have examined the accessory nature of guarantees, which, as a result of the long-standing judicial tradition, has become the cornerstone for guarantees in the codified legal systems. In contrast, modern commercial practices have consolidated autonomous guarantee instruments which, because of their severance with the cause, have certainly given rise to discussion in the field of legal doctrine although this has not impaired the widespread use of these instruments. As a last variable, stand the public sector creditors and their interest in obtaining guarantees that grant prompt liquidity to their claim.

The influence variables having been identified, the next step is to analyze specific cases in order to analyze the accessory and autonomous nature in guarantee instruments issued by insurance companies in favor of public beneficiaries. These instruments will stand, to a greater or lesser extent, closer to one or another end between accessory guarantees and autonomous guarantees, which will be an indicator of their liquidity level from the beneficiary's perspective. For the purpose of this work, liquidity refers to how precise or strict the call process is when it comes to satisfying the amount guaranteed.

It should be noted that this work is not aimed at analyzing in detail the systems under consideration; this would be impracticable mainly due to the unique characteristics of the guarantee instruments required by different government entities within the same country, namely the federal government, the decentralized entities, the customs authorities, etc. For practical purposes, this work analyzes the nature of guarantees that cover obligations to do in the countries under study and the steps the beneficiary has to follow in order to call on a guarantee

The following table shows, in comparative form, the characteristics examined for accessory and autonomous guarantees; we will next proceed to identify these elements in different countries.

	Accessory nature	**Autonomy**
Existence	The existence of the guarantee is subordinated to the main obligation.	Existence is severed from the underlying cause or relationship.
Scope	Liability is limited to the original obligation.	Liability is established according to the terms of the guarantee.
Defenses	It is possible to raise the defenses arising from the underlying contract.	The only defenses that can be raised are those set up in the guarantee.
Burden of proof	It lies on the creditor who must prove the existence of default.	It lies on the guarantor and is based on the guarantee contract.

Guarantees in favor of government entities – The insurance sector in different countries

Performance insurance - Colombia

In Colombia, performance insurance is the instrument offered by insurance companies to protect the contracting entity from direct damages derived from the occurrence of an insured risk, defined as: total or partial default on contractual obligations, late performance, loss attributed to the contractor arising from partial deliveries not provided for in the contract, payment of fines and of pecuniary penal clause (Fasecolda, 2015), Legal opinion in Colombia has concluded that the insurer's obligation to compensate arises when the damage to property occurs (Reyes and Baquero, 2011); there must be evidence of a direct relationship with the cause.

With reference to the burden of proof, the obligation to prove default attributable to the contractor lies with the insured, who must, in addition, prove the amount of the loss and that said damages arise from risks expressly assumed by the insurer (Pérez Rueda, 2012)

As regards the extent of the liability, based on the application of the compensatory principle, the insurance cannot be a source of enrichment; then, in spite of the fact that the default might be proved, compensation will not proceed if it cannot be proved that damage has resulted from it. (Fasecolda, 2015)

As opposed to surety bonds ruled by the Civil Code, where a third party assumes somebody else's obligation, in the performance insurance, the insurer does not assume third party's obligations, but obligations which become the insurer's own obligations by virtue of the issuance of the policy (Pérez Rueda, 2012).

As regards the claim, the public entity must comply with the administrative proceedings whereby the loss is declared and the damages are assessed. As part of these proceedings, the government entity must call the contractor and the contractor's guarantor to a meeting where the former can raise defenses. Once the default has been declared, notice is given to the insurer of the motivated administrative act, which serves as claim. With this claim, the insurer can raise objections by filing recourse through government channels, a process in which the burden of proof is shifted; the insurer must state the legal or contract-based reasons that give rise to their claim of exemption (Rusinque, 2014).

We should draw our attention to the fact that when the contracting entity's guarantee is an on-demand bank guarantee, the government entity must comply with the proceedings provided for by the law to declare the default, even though it is not necessary to prove it (DNP, 2016).

Surety policies – Ecuador

In Ecuador, the same as in Colombia, surety policies are considered to belong to property damage insurance.

Surety bonds in the form of insurance policies are among the guarantee instruments included in the public procurement system of Ecuador. In order to be accepted by the contracting entity, these must be unconditional, irrevocable and on-demand surety bonds (Section 73, Organic Law for the National Public Procurement System in Ecuador, 2008)

Surety policies issued by insurance companies are governed mainly by the Organic Law for the National Public Procurement System and the General Insurance Law. The surety policy issuer becomes the main differentiating element between surety policies under the private insurance system and surety bonds governed by the Civil Code. The characteristics of the latter are their accessory nature and subsidiarity and the fact that they grant the surety the rights of excussio and division. Conversely, in the case of private surety policies, the insurer and the debtor become joint-and-severally liable and the former waives the rights of excussio and division (Jaramillo, 2010).

A distinctive feature of the guarantee system in Ecuador is the accessory nature of the surety policies issued by insurers as regards their existence (Jaramillo 2010), since the existence of the guarantee is dependent upon the existence of the guaranteed obligation. As far as the scope, Section 44 of the Insurance General Law rules that "the insurance company liability shall not exceed the maximum amount stated in the policy or its annexes"; additionally, "in no case shall the insurance company be bound to an amount higher than the amount owed by the debtor" (Pazmiño, 2013).

It should be noted that the accessory nature of surety insurance is not concerned with enforceability since the defenses arising from the main contract cannot be raised against the insured. The law provides that the obligation assumed by the insurer is unconditional, but the fact is that the obligation of the insurer is due and payable only when the default has been proved. For the claim to be admissible, the public entity must give notice to the insurer of the unilateral termination of the contract that originates the call; this notice "will be accompanied by certified copies of technical and financial reports related to the obligations of both the contracting entity and the contractor" (Pazmiño, 2013). In this sense, it is the obligation that is unconditional, and this obligation comes into being with the default proved by the administration pursuant to the administrative process, which is recorded in the documents that evidence said default.

In summary, in Ecuador surety policies issued by insurance companies to guarantee the fulfillment of obligations before government entities have accessory nature as long as their existence is tied to the main obligation; nevertheless, nothing in the beneficiary creditor-debtor relationship shall be used to avoid paying any loss. Once the default has been proved following pertinent administrative procedures, the insurer has the obligation to pay on the beneficiary's demand.

Surety insurance - Spain

As in Colombia and Ecuador, surety insurance in Spain is considered a property damage insurance. The purpose of surety insurance in Spain is to compensate for the damages caused by the debtor's default. In his work on this subject, Carlos Hoyos (2012) points out that the function of surety insurance is not to substitute for the principal debtor, but compensate the beneficiary creditor for the economic damages caused by the default.

The distinctive feature of surety insurance in Spain compared to other systems is the fact that, although it is only one legal business, it contains three different relationships under three different names. The relationship between the insurer and the policyholder is formalized by means of the insurance policy, while the relationship between the insurer and the insured or beneficiary is formalized in the individual certificate issued on the basis of the policy; the third contract is entered into by the contractor (debtor) and the contracting entity (beneficiary). In this construct, the insurer is at risk only the moment it issues an individual certificate (usually called endorsement) which is the specific guarantee in favor of the insured covering the obligations in a given contract entered into between the insured and the contracting entity.

We start from the elements of civil surety bonds, defined in Section 1822 of the Spanish Civil Code as a contract whereby "one of the parties undertakes to fulfill a third-party's obligation should the latter fail to do so" (Civil Code, 1889). This definition refers to an accessory obligation, to which the rights of preference and excussio apply (Section 1830) and which is based on a valid obligation (section 1824)

The solution in Spain to the problems posed by surety bonds has been to include in the surety insurance certificate the obligation of the insurer to pay the compensation with no other requirement than the mere demand of payment, without consideration of the appropriateness of the claim (Pérez Calvo, 2013). This is possible based on the free will principle established in Section 1255 of the Civil Code. In spite of the various opinions regarding this type of autonomous coverage, Pérez Calvo considers that it has grown stronger and is nowadays widely accepted and recognized by judicial precedent as a special type of guarantee.

By means of a surety insurance certificate in the manner stated above, the obligation to pay assumed by the guarantor becomes autonomous with respect to the main obligation guaranteed, which means that it is not necessary to prove the default to call on the guarantee. The only valid defense the insurer can raise is the effective fulfillment of the guaranteed obligation, which would turn the claim inadmissible. Judicial precedent shows the insurer can object to payment by giving evidence that the obligation has been fulfilled, so that, when there is a demand of payment, default is presumed; the burden of proof lies on the insurer and it will consist in demonstrating that the obligation has been fulfilled by their client (Pérez Calvo, 2013).

Thus viewed, surety insurance allows beneficiaries to settle their claims, getting over the problems of accessory guarantees. Within this frame, it is in the insurer's interest, to state–for the insurance purpose and with respect to the obligations under the insurance–what is meant by fulfillment or default and how they are determined.

Conclusions

A summary of the findings is presented in the table below, together with the definitions of accessory and autonomous nature and a classification of the systems under scrutiny. There are some notes to clarify special features.

	Accessory nature	**Autonomy**	**Colombia**	**Ecuador**	**Spain**
Existence	The existence of the guarantee is subordinated to the main obligation.	The existence is severed from the underlying cause or relationship	**Accessory nature**	**Accessory nature**	**Accessory nature**
Scope	Liability is limited to the original obligation	Liability is established according to the terms of the guarantee	**Accessory nature**	**Accessory nature**	**Accessory nature**

Defenses	It is possible to raise the defenses arising from the underlying contract	The only defenses that can be raised are those set up in the guarantee.	**Accessory nature**	**Autonomy** (Note) Defense: Administrative proceedings	**Autonomy** (Note) Defense: the debtor has fulfilled obligations
Burden of proof	It lies on the creditor, who must prove the existence of default	It lies on the guarantor and is based on the contract of guarantee	**Accessory nature**	**Accessory nature**	**Autonomy** (Note) The insurer must prove fulfillment

- The term "on-demand" is broadly used; however, it is worth noting that insurance companies often assume accessory obligations and those in which the compensation is due and payable only when certain conditions are met. The liquidity of guarantee instruments issued by insurance companies is determined by how tight and demanding is the condition the beneficiary has to fulfill.
- In Ecuador and Spain, guarantee instruments in favor of government entities contain autonomy features. The transition from accessory nature to autonomy can be accounted for by the increasing use of autonomous guarantees between private parties and the defense of public interest.
- The performance insurance in Colombia is a limited liquidity instrument; the administrative proceedings for the claim are exacting on the beneficiary entity, the debtor can raise objections during such proceedings and, once these have been completed, the insurer's objections are still a possibility. The conclusion is that the performance insurance before government entities in Colombia includes features of an accessory nature and has low liquidity level.
- In Ecuador there is a strict position of the law with respect to guarantee instruments in favor of government entities. However, the autonomy of the instruments is limited to the defenses that can be raised; the insurer can only demand documented proof of the default pursuant to the proceedings provided for to make the compensation due and payable. In the other aspects studied, the surety policies are of an accessory nature and hence, liquidity is higher than in Colombia, but still retaining features of a clearly accessory nature.
- In Spain the insurance certificate determines the insurance-beneficiary relationship, including the call-on proceedings. The disadvantages of surety bonds have been corrected by means of certificates where the insurer's obligation is defined as payable on demand, without it being possible to raise any defenses other than those stated in the guarantee contract. This alternative maintains the causal relationship and the accessory nature as far as the existence and the scope of liability. Notwithstanding, the instrument may be considered autonomous as regards the defenses that can be raised and the burden of proof, which enhances the creditor position and, consequently, it turns out to be the most liquid instrument when compared with the instruments in Colombia and Ecuador.

- These conclusions apply only in the context of guarantees for the public sector. Between private parties, equilibrium between the parties applies, and hence liquidity conditions are negotiated freely.

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