

Validity of Bank Guarantees under Turkish Law

Introduction

A bank guarantee (or a letter of guarantee or L/G) is accepted as a specific type of guarantee agreement under Turkish law. This characterization was first made by the Court of Appeal half a century ago and has been consistently applied to guarantees subject to Turkish law since then.

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This characterization, even though seems perfectly harmless, had important consequences in determining when the liability of the guarantor will cease to exist.

In this article, we will examine the consequences of such characterization, why and how the validity of the bank guarantees is affected by it and the deviation created between the Turkish and international banking practices as a result.

Legal Characterization

The Court of Appeal, in its famous decision in 1969, characterized bank guarantees as guarantee agreements. The court further put that the “guarantee agreement” between the bank and the beneficiary was totally independent and separate from the underlying relationship between the beneficiary and the principal. This approach is in parallel with the URDG 758 regulations.¹

¹ ICC Uniform Rules for Demand Guarantees (URDG 758) Art. 5A.

According to the interpretation of the high court, by entering into a guarantee agreement with the beneficiary, the guarantor was undertaking the principal's performance towards the beneficiary. The court borrowed the concept of "undertaking of a third party's performance" found in the Code of Obligations and declared that the bank guarantees constituted a specific case of this concept.

Limitation Period

The immediate consequence of characterizing bank guarantees as guarantee agreements is that they will be subject to the general rule on limitation period in the Code of Obligations.

Article 146 of the Code of Obligations (2011), in parallel with the relevant provision of the previous Code of Obligations (1926), stipulates that all claims become time-barred after ten years unless otherwise provided by law.

The code, in its following article, brings some exceptions to this general rule on limitation period which stipulate a shorter period than 10 years, however claims under guarantee agreements are not mentioned within these exceptions.

Given that a letter of guarantee is a specific type of guarantee agreement and claims arising from guarantee agreements (as all other types of agreements) are subject to 10-year limitation period, provided that the risk occurred within the validity (on or before the expiry date) of the letter of guarantee², the beneficiary has the right to make a claim against the guarantor within 10 years starting from the occurrence of the risk guaranteed or the expiry date of the guarantee, if the date of such occurrence cannot be identified.

Criticism followed as this approach extinguished the difference between bank guarantees with and without an expiry date. Not knowing whether the beneficiary of a letter of guarantee would make a claim in connection with such guarantee, the banks had to wait for another 10 years following the expiry date and thus did not release the collateral granted by the principal and the principals

² The burden of proof for proving that the risk occurred before the expiry date is on the beneficiary.

had to go on paying bank commissions for the whole period and could not get their collateral released.

The deviation from the international banking practice was another crucial issue. A counter-guarantee with a similar expiry date with the connected bank guarantee might have expired on its expiry date while the bank guarantee would survive another 10 years without relying on a solid collateral. There have been many cases where the carefully written counter-guarantee expired on its expiry date while the bank guarantee survived and the guarantor had to pay the beneficiary without being able to make a claim against the counter-guarantor on the already expired counter-guarantee.

Amendment to Law

In 1981, the Turkish lawmaker, in order to find a solution to the issue and uniform the Turkish and international banking practices, added a second paragraph to the article related to the undertakings of a third party's performance:

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In the case of an undertaking made for a certain period of time, it is permissible to determine that the liability of the undertaker shall cease unless a written presentation is made until the expiry date.³

In its essence, adding this paragraph to the Code of Obligations did not automatically solve the problem or bring Turkish law in line with the international banking practice. It rather gave the banks the room to phrase their guarantee letters in a way that they would be released from their liabilities at the expiry date.

Conditional Validity Clauses

The guarantor must be very careful in preparing the text of the letter of guarantee in order not to be trapped with a liability that will survive for 10 years starting from the expiry date of the guarantee. Together with the guarantor, the principal is also locked as the collateral granted for the guarantee will not be released by the bank

³ Turkish Code of Obligations, Art. 128/2.

and the customer's credit line will be used in vain throughout this period.

As mentioned above, the new legislation has not completely brought Turkish banking law in line with international banking law and practice and unlike URDG 758, does not expressly state that "A presentation shall be made to the guarantor ... on or before expiry."⁴ or "Whether or not the guarantee document is returned to the guarantor, the guarantee shall terminate on expiry...".⁵ The lawmaker rather sought for creating a remedy that will help the guarantors to dispose of their liability under the letters of guarantee.

The added paragraph to Art. 128 of the Code of Obligations implies that the validity clause must include, together with an expiry date, a condition which allows the beneficiary to make a presentation related to the guarantee only on or before the expiry date. When the validity clause includes such condition, the beneficiary cannot make a presentation after the expiry date, therefore the guarantor is released from its liability as of such date.

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Drafting a Validity Clause

As explained above, a bank guarantee with an expiry date may be called upon by the beneficiary even after its expiry date if it is not drafted correctly. Therefore, the guarantee letters must be drafted very carefully:

- If the validity clause only includes the expiry date, the liability of the guarantor for risks which occur within the validity of the bank guarantee will continue for 10 years starting from the expiry date of the guarantee.

This letter of guarantee is valid until xx.xx.xxxx.

- If the validity clause includes an expiry date and even states that the letter of guarantee will become null and void after that date, the liability of the guarantor for risks which occur

⁴ ICC Uniform Rules for Demand Guarantees (URDG 758) Art. 14A.

⁵ ICC Uniform Rules for Demand Guarantees (URDG 758) Art. 25B.

within the validity of the letter of guarantee will continue for 10 years starting from the expiry date of the guarantee.

This letter of guarantee is valid until xx.xx.xxxx and will be null and void after this date.

- If the validity clause includes an expiry date and states that the letter of guarantee will become null and void unless a written claim is made until that date, the guarantor will be released from all its liabilities as of the expiry date of the guarantee.

This letter of guarantee is valid until xx.xx.xxxx and will become null and void unless a written claim is made until this date.

Conclusion

Even though the Turkish courts have consistently rendered verdicts in the same direction on the validity of bank guarantees for almost half a century, in practice there are still countless examples where the expiry date clauses are not phrased correctly and disputes in connection with the validity of the bank guarantees are brought before the courts.

The principals of the bank guarantees must instruct their banks to act in utmost care while drafting the guarantees subject to Turkish law and double-check the wording of the whole text but especially the validity clauses in order not to be locked with the 10-year limitation period.

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