THE BANK'S OBLIGATION TO PAY UNDER LETTERS OF GUARANTEE.

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DEDICATION

This thesis is dedicated to my parents, my dear wife Nadia and to my little blossoms Farah and Samir.
DECLARATION

I hereby declare that unless otherwise mentioned by quotation or reference, this thesis has been entirely and solely composed by me. It has not been published or submitted for another degree.

Bassam Al-Talhouni

June, 18th 1997.
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ABSTRACT

The aim of this thesis is to discuss a bank's obligation to pay under letters of guarantee in English law, the Uniform Rules of the International Chamber of Commerce and the United Nation Commission on International Trade Law (UNCITRAL).

Letters of guarantee that are issued by other financial institutions as surety or by insurance companies fall outside the scope of this thesis.

This thesis is divided into six chapters. Chapter I outlines the importance of the letter of guarantee and the legal issues which are discussed in the rest of the thesis. Chapter II examines the legal nature of letters of guarantee by highlighting the problem of inconsistency of terminology, and by tracing the sources of law which regulate letters of guarantee. It examines a bank's obligation to pay under different types of letters of guarantee, and considers the parties to these instruments. Chapter III discusses the legal nature of a bank's obligation to pay. This includes the establishment of the bank's obligation to pay and some other issues related to this obligation, such as the mechanism of payment, the principle of independence and the duty of verification. Chapter IV analyses the effect of fraud and interlocutory injunctions (interim interdicts) on a bank's obligation to pay. This encompasses questions of evidence of fraud, the bank's role in preventing fraud and the effect of the court's injunction on the bank's obligation to pay. Chapter V discusses the ambit of the bank's duties and responsibilities under letters of guarantee. Issues such as the bank's duty to pay the proper beneficiary and the bank's limitation of liability are discussed in this chapter. Chapter VI discusses the problems associated with the issue of the choice of law in determining the law applicable to the bank's obligation to pay. It examines the principles that are applied by the English courts in deciding the applicable law to letters of guarantee and the effect of these principles on the bank's obligation to pay. The thesis is completed by a conclusion.
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CHAPTER ONE
INTRODUCTION

Letters of guarantee have become very important and useful instruments in both international and domestic transactions. Their ability to back up all kinds of transactions has attracted the attention of contracting parties seeking to cover financial and non-financial risks. They were accordingly described by Kerr L.J. in the case of Harbottle v. National Westminster Bank Ltd as the "life blood of international commerce". The importance of this commercial instrument has been also emphasised by Akner L.J in United Trading v. Allied Arab Bank, where he said that:

"Letters of credit and performance bonds are part of the essential machinery of international commerce."  

As a result of the competitive trade situation, big contractors and buyers insist on obtaining a reliable type of security from counter-parties to assure them of their capacity to perform their obligations under the contract.

In international trade the buyer and seller are normally separated from one another not only by distance but also by differences in language and culture. It is rarely possible for the performance of obligations to be simultaneous and the performance of contracts therefore calls for trust in a situation in which the parties are unlikely to feel able to trust each other unless they have a long-standing and successful relationship. A gap of potential mistrust thus exists

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which is often bridged by the issuance of a letter of guarantee by a third person, usually a bank.

Letters of guarantee are commonly required in the case of construction contracts which involve a substantial period of time before completion and during which any number of events may occur which may delay or even prevent full performance of the contract by the contractor. This may be due to problems within the contracting company itself or external factors, such as changes in political and/or economic circumstances, or even unsuitable physical conditions on the contracting site, e.g. abnormal weather. Individually or collectively, factors such as these may cause delay or render completion impossible. Employers think protection is necessary due to the large amount of money involved in projects, coupled with the fact that contractors cannot always fully be trusted. Contractors have been known to abandon incomplete projects or to increase their prices after the contract has been awarded and the bidding competition has subsided. From the beneficiaries' point of view, therefore, letters of guarantee are attractive because they provide an incentive to motivate the contractors to perform their contracts to the letter. They are also advantageous to banks and contractors because they are simple to use. The banks have encouraged the growth of the use of letters of guarantee because they increase business and income. For contractors, letters of guarantee appeared to be cheaper and easier to obtain than surety bonds.

Under an international contract of sale the need for the buyer to insure against the failure of the seller to fulfil his obligations to deliver the goods and for the seller to insure against the failure of the buyer to pay the purchase price has resulted in the increasing use of letters of guarantee. If, therefore, the buyer is uncertain whether the seller will be able to supply the goods, or to
complete the contract in a construction undertaking, the seller or supplier may ask the buyer for a letter of guarantee.

Letters of guarantee can fulfil the expectations of all parties, the bank, the applicant and the beneficiary, that the funds of the letter of guarantee shall be available promptly to the beneficiary when there is a demand on the letter of guarantee. This has been emphasised by Hirst J. in *Siporex v. Banque Indonsuez* 4 where he said that:

"The whole commercial purpose of a performance bond is to provide a security which is to be readily, promptly and assuredly realizable when the prescribed event occurs".5

Despite the widespread use of letters of guarantee in international and domestic trade, they are, however, still to be considered as a "relatively new legal phenomenon".6 This view made Denning L.J. in *Edward Owen Engineering Ltd v. Barclays Bank International Ltd* 7 say that:

"A performance bond is a new creature so far as we are concerned."

There are relatively few studies dealing specifically with letters of guarantee. Commentators apparently prefer to focus on the better-known letters of credit. The English Law Reports also contain few decisions relating to the construction of letters of guarantee.8 All this may be attributed to the questionable impression among some legal writers that letters of guarantee are identical to that well-known international commercial instrument, the letter of

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5 Ibid at p. 158.
7 [1978] All ER 976.
credit. It seems that under a similar impression, Denning L.J. in the case of Edward Owen has said:

"Performance bonds stand on a similar footing with letters of credit"\(^9\)

The aim of this thesis is to discuss a bank's obligation to pay under letters of guarantee in English law, under the Uniform Rules of the International Chamber of Commerce and the Convention of the United Nation Commission on International Trade Law (UNCITRAL). The bank's obligation to pay is considered the most significant issue under letters of guarantee. In fact it constitutes the fundamental object behind the idea of obtaining a letter of guarantee. Beneficiaries therefore would expect smooth and undisputed payment by the bank when the event covered by the bank's obligation to pay has occurred.

The second chapter of the thesis therefore examines some of the issues related to this significant obligation by examining the legal nature of letters of guarantee, so as to sort out the confusion which exists in the courts and among the legal writers as a result of inconsistency in labelling letters of guarantee.

Such inconsistency undoubtedly has a significant effect in determining the nature of the bank's obligation to pay under a letter of guarantee as being a primary or secondary one. The similarities between letters of guarantee and the American standby letters of credit are also underlined. The chapter also clarifies the parties to letters of guarantee and the mechanism under which letters of guarantee work in domestic and international transactions.

The legal nature of the bank's obligation to pay is discussed in the third chapter. This chapter is concerned with analysing the procedures according to

which the bank's obligation to pay becomes effective as a result of the issuance of a letter of guarantee. It accordingly focuses on the principle of the independence of the bank's obligation to pay from the parties' disputes relating to the principal transaction. Since the bank's obligation to pay is triggered by the beneficiary's demand, this chapter discusses the conditions and the difficulties that might arise, such as the use of telecommunication methods to demand a letter of guarantee. The approach of the Uniform Rules of the International Chamber of Commerce to these issues is also examined. It highlights the duties that the bank has to carry out when it receives a beneficiary's demand before it proceeds to payment. Some important issues such as the validity of the letter of guarantee have started to have a serious effect on the principle of a bank's obligation to pay, particularly in the absence of an expiry date clause in the letter of guarantee. The chapter is therefore concerned with finding an alternative solution to the problem of the absence of the expiry date clause. It also demonstrates some cases where the bank is not discharged from its obligation to pay, despite the existence of an expiry date in the letter of guarantee.

The effect of fraud and interlocutory injunctions on the bank's obligation to pay discussed in chapter four. The chapter is mainly devoted to the study of the concept of fraud as a defence against the bank's obligation to pay under the letter of guarantee. It investigates tendencies of English courts in the treatment of fraud. It analyses the different approaches that are adopted by these courts in dealing with fraud. The bank's role in preventing fraud and the effect of third party fraud on the bank's obligation to pay are amongst the issues that are dealt with under this chapter. A comparison between the approach of the American courts to fraud in standby letters of credit and the English courts in letters of guarantee has been also made. The question of the
evidence of fraud and the effect of the courts' injunctions on the bank's obligation to pay are also discussed.

Chapter five discusses the ambit of the bank's duties and responsibilities under letters of guarantee. It starts by emphasising the duty of the bank to pay the proper beneficiary. The bank accordingly cannot be discharged from its obligation to pay unless it pays the proper beneficiary. The chapter investigates the legal ground for the insertion of the exemption clauses by the banks under the letter of guarantee. It raises the question of the extent to what the bank could rely on these clauses to exempt itself from liability. It also raises the question of whether a beneficiary under a letter of guarantee owes the bank a duty to mitigate its damages.

Chapter six examines the problems associated with the issue of the choice of law in determining the law applicable to the bank's obligation to pay. Since the choice or absence of a choice of law governing the contract will have a significant impact on the bank's obligations under the letter of guarantee, including its obligation to pay, this chapter accordingly examines the effect of the conflict of law rules on the bank's obligation to pay. It starts by demonstrating briefly the general principles of the conflict of law rules which are applied by the English courts together with the provisions of the Contracts (Applicable Law) Act 1990 so as to consider the impact of these rules on letters of guarantee transactions. The thesis is completed by a conclusion which highlights some of the significant legal issues it has covered.

In order to analyse the above problems, I used various methods of research. Firstly, I researched in libraries. Secondly, I interviewed and consulted several lawyers in the field of commercial finance. Both the library research and interviews were also carried out at the International Chamber of
Commerce. Thirdly, I collected several bank standard forms in current use and other documents. Lastly, I sent a questionnaire to ten banks in United Kingdom and received replies from four of the banks: Barclays Bank, National Westminster Bank, Bank of Scotland and Lloyds Bank.
CHAPTER TWO
THE LEGAL NATURE OF LETTERS OF GUARANTEE.

2.1 General.

The object of this chapter is to describe letters of guarantee, their function and how they operate in practice. It is accordingly concerned with examining some of the terminological confusion in describing letters of guarantee, which results from inconsistency in the use of these terms.\(^\text{10}\) The sources of law which regulate letters of guarantee and the parties to the letters of guarantee are also examined. This chapter also reviews the primary classification of the letters of guarantee and the different types of letters of guarantee that are issued within the primary classification. And finally a distinction is drawn between letters of guarantee and commercial letters of credit in order to sort out a misconception over the two instruments, according to which the letter of guarantee has been always believed to be the "mirror image" of the commercial letter of credit.

2.2 A PLEA FOR TERMINOLOGY.

There is no uniform terminology for independent letters of guarantee in international trade or English banking practice. In the banking practice these instruments have been given various names. They are known, for example, as contract guarantees, guarantees, bank guarantees, demand guarantees or performance bonds. These terms are interchangeable, the use of these terms had led to terminological inconsistency. Such inconsistency is without doubt confusing and against the independent legal nature of the bank's obligation to

pay under these instruments. Therefore, labelling these instruments as "contract guarantees", for example, is too vague, as all of these instruments are of a contractual nature.

The term "bank guarantees" is also confusing, since in English law "bank guarantees" are in every respect comparable with suretyship. Accordingly, the terminological confusion between letters of guarantee and ordinary bank guarantees has resulted in a conceptual confusion between the two instruments. The difference in the nature of the instrument can be deduced from the following definition of the ordinary bank guarantee. These instruments are defined as:

"A collateral agreement for performance of another's undertaking. An agreement in which the guarantor agrees to satisfy the debt of another (the debtor), only if and when the debtor fails to repay (secondarily liable). An undertaking or promise that is collateral to primary or principal obligation and that binds guarantor to performance in event of nonperformance by the principal obligor".

The most significant difference between them is the nature of the bank's obligation to pay. In the case of a letter of guarantee, the bank's obligation to pay is an independent and primary obligation to pay upon the beneficiary's demand. On the other hand the bank's obligation to pay under the ordinary bank guarantee is of a secondary nature where the guarantor, or surety,

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12 Thatcher A., & White N. "Performance Bonds And Bank Guarantees" [1992] Queensland Law Society Journal at p.297. They believe that the term "bank guarantee" is arguably a misnomer. From the authors' point of view "The intention of most 'bank guarantees' is that they be regarded as true performance bonds, but the use of the word "guarantee" only serves to confuse the issue."; See also Goldsmith E., "Performance Bonds In English Courts" [1978] Droit Et Practique Du Commerce International 151.

assumes a liability to answer for the debt or default of another. The guarantor’s liability is therefore secondary in character, in that the guarantor’s obligation to pay does not arise until the principal debtor has defaulted and is in principle limited to the liability of the principal debtor. This also means that the bank’s obligation to pay would be affected by reasons that might emanate from the underlying relationship of the parties. Accordingly, under the ordinary bank guarantee, the beneficiary’s right to recourse against the guarantor is limited to the situation in which he is able to prove that he sought performance or damages from the account party in the first place. Moreover, the guarantee might be considered to be discharged if the underlying relationship between the parties for any reason is discharged. Whereas in the case of a letter of guarantee, the beneficiary has the right to demand payment directly from the bank and regardless of any opposition by the account party.

In Edward Owen Engineering Ltd. v. Barclays Bank International Ltd., Lane L.J., has noticed the confusion in labelling letters of guarantee as guarantees. The learned judge refused to characterise these instruments as guarantees. He said:

"[The Appellant] submits that, since this document between the two banks is expressed to be a guarantee, the bank is under no liability to pay *prima facie* unless, first of all, there is a principal debtor and secondly some default by the principal debtor in his obligations under his contract with the seller. Since, he submits, no such default on part of the seller

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15 Hapgood M., Paget’s Law of Banking (11th ed. 1996), at p.618 where he defines the guarantee as "[A] promise to be answerable for the debt of another. As such, it is a secondary obligation, depending for its meaning and existence upon the primary obligations of the principal debtor".

was suggested, the guarantee does not come into effect. Although this agreement is expressed to be a guarantee, it is not in truth such a contract. It has more of the characteristics of a promissory note than the characteristics of a guarantee."

The same terminological confusion took place in the United States between standby letters of credit and ordinary bank guarantees. Many courts have started to recognise the distinction between standby letters of credit and the ordinary bank guarantees. For example, in the case of the *American Insurance Association v. Clarke* the court stated that:

"The 'central distinction' between the two is that the standby credit creates a primary liability on an original obligations - to pay on the presentation of documents - whereas the contract of a guaranty creates a secondary liability on the pre-existing obligation of another - to pay in the event that the other does not".

Again the distinction between the standby letter of credit and the bank guarantee has been also emphasised in the case of *Republic National Bank of Dallas v. Northwest National Bank of Fort Worth* where the court stated that:

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17 Ibid., at p.986.


19 854 F.2d 1405 (D.C. Cir. 1988)

20 Ibid.

21 578 S.W.2d 109 (Tex. 1978).
"Since a guarantee is ancillary to the underlying contract, a dispute as to the rights and obligations of the guarantor can only be resolved by a factual determination of the rights and obligations of the guarantor can only be resolved by a factual determination of the rights and obligations of the parties to the underlying contract....A bank that issues a credit, however...engages its own credit...If a conforming presentation of documents is made, the issuer of a credit is obligated to pay without reference to the rights and obligations of the parties to the underlying contract."

The court’s decisions in these two cases suggest that there is a difference in the nature of the bank's obligation to pay under an American standby letter of credit and an ordinary bank guarantee. As it will be explained later, the most significant characteristic of the bank’s obligation to pay under a letter of guarantee and a standby letter of credit is the principle of independence.

As it has been mentioned earlier, terms such as "on demand" or "first demand" guarantee are also used in banking practice to refer to the independent letters of guarantee. These terms can also be criticised as being misleading since they only cover one type of letter of guarantee which is normally payable upon the beneficiary's first demand without the need for any additional documents to support his demand. Other terms such as "automatic guarantees" may be also found by certain legal writers. This term may be criticised as not being a legal expression.

The most common term that is in use by the English courts, in banking practice and in legal writing is the term "performance bond". The use of this term can be criticised on the ground that a performance bond is an

22 Ibid. at p.114.

23 For more on this type of letter of guarantee see infra p.41.

undertaking of an insurance company or of a surety company to indemnify the beneficiary against the account party's failure to perform the underlying contract. A surety's obligation is secondary to that of the account party, however, and the surety becomes liable only when the account party has in fact defaulted on its obligation. Thus, unlike the issuer of a letter of guarantee, the surety does not pay the buyer automatically upon the buyer's assertion that the seller has not performed: it may first investigate the truth of the assertion.

If the surety determines that the seller has fulfilled the contract, then it may refuse to pay the buyer. The surety may also assist in any defence against the buyer that would be available to the account party. Furthermore, the surety retains the option of actively intervening to ensure performance either by demanding that the seller remedy the defect in its performance or by completing the contract itself.25

The terminological confusion as a result of inconsistency has been emphasised by legal writers in several occasions. Professor Goode states that:

"There is a considerable confusion of thought, even among experienced lawyers, as to the nature of the documentary guarantee. This is no small measure due to the fact that the market itself uses a wide range of labels to describe the same legal phenomenon. Demand guarantees, performance bonds, performance guarantees, standby letters of credit, all are legally synonymous in their essential character".26

The terminological inconsistency has been also noticed by Professor Jack where he says that:


"In the absence of an authority to define terms it appears that 'bond' and 'guarantee' have been used interchangeably, sometimes prefaced by 'performance' and sometimes also by 'demand' or by 'first demand'.

Perrignon believes terminological inconsistency is misleading. He states that:

"Banker's undertakings, or "bank guarantees" as they are sometimes (and somewhat misleadingly) called, are identical to performance bonds, except the need not be under seal".

Another example of the confusion in terminology may be derived from the words of Penn where he believes that "on-demand" guarantee is one type of performance bond. He says that:

"The clearing banks have traditionally favoured the 'on-demand' type of performance bond, believing that such bonds would enable them to stand clear from any dispute between the parties to the underlying contract."

As has been shown earlier, there is a significant difference between on-demand letters of guarantee and performance bonds. In fact performance letters of guarantee constitute one type of letters of guarantee. Other types of letters of guarantee include: tender, advance payment, retention and maintenance letters of guarantee. In practice any of these types could take the form of "on-demand" or "conditional" letters of guarantee. It is inaccurate therefore to denominate all these different types of letters of guarantee as performance bonds.

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27 Jack R., *Documentary Credits*, (2nd ed. 1993) at p.271


29 Thatcher A., & White N. "Performance Bonds And Bank Guarantees", supra, at p.297 where the authors say that "Performance bond ..... is often called a "bank guarantee" ..... that term is arguably a misnomer".

30 Penn G., "Performance bonds: are bankers free from the underlying contract?"[1985] *Lloyd's Maritime and Commercial Law Quarterly* 132
The terminological confusion is also reflected in some of the English courts decisions, where variant terms were used by the courts to describe these instruments. Many terms such as "bonds", "performance bonds", "performance guarantees", "bank guarantees" and "demand guarantees" used. For example, in the case of Edward Owen Engineering Ltd v Barclays Bank International Ltd\textsuperscript{31} the court appeared to be confused over the appropriate term. In this case Lord Denning said:

"This case concerns new business transaction called a performance guarantee or a performance bond'.."\textsuperscript{32}

In Harbottle (Mercantile) Ltd v National Westminster Bank Ltd\textsuperscript{33} the court also appeared to be confused over the terms "performance bonds" and "guarantees". In this case Kerr J stated:

"All the contracts provided that the plaintiffs were to establish a guarantee confirmed by a bank of 5\% of the price in favour of the buyers. These were in effect to be performance bonds. They were called guarantees simpliciter, but their purpose was to provide security to the buyers for the fulfillment by the plaintiffs of their obligations under the contracts" \textsuperscript{34}

Again the same confusion can also be seen in the words of Hirst J. in the case of Siporex v. Banque Indonsuez\textsuperscript{35} The learned judge said that

\begin{itemize}
\item \textsuperscript{31} [1978] Q.B. 159.
\item \textsuperscript{32} Ibid. at p.164.; see also Schmitthoff C., "Bank's liability under unconditional bond" [1977] Journal of Business Law 351 at p.352.
\item \textsuperscript{33} [1978] Q.B 146.
\item \textsuperscript{34} Ibid at p.149
\item \textsuperscript{35} [1986] 2 Lloyd's Rep. 146.
\end{itemize}
"So far in this judgment I have usually used the word guarantee rather than performance bond, and early in the argument I received a salutary warning from Mr. Hallgarten on behalf of the defendants not too readily to adopt the latter categorization, especially since neither the word "performance" nor the word "bond" actually appear in the letters dated ... The term "performance bond" has, however, become a common and commercially convenient term for denoting such letters and, while remaining mindful of Mr. Hallgarten's warning, I shall use that term interchangeably with guarantee or undertaking when I refer to them".36

No attempt has been made by the International Chamber of Commerce to solve the problem of nomenclature. Moreover, it seems that even the URCG did not escape the confusion. Art. 1 of the rules provides:

"These Rules apply to any guarantee, bond, indemnity, surety or similar undertaking, however named or described 'guarantee'...."

Although the above article enumerates various commercial instruments, it nevertheless refers to them as guarantee. Such a reference is misleading. As has been mentioned earlier, this term should be avoided as it might lead to confusion in banks, especially in countries where the term "guarantee" suggests that the banks' obligation to pay is a secondary and not primary, as the case in English law.

The URDG also made the same mistake in denominating these instruments. This is clear in the language of Art. 2(a) of the rules which used the term "guarantee" to describe these instruments. The article states:

"For the purposes of these Rules a demand guarantee (hereinafter referred to as 'Guarantee') means any guarantee, bond or other payment undertaking, however

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36 Ibid. at p. 150.
named or described, by a bank, insurance company or other
person (hereinafter called the 'guarantor')."

This article may be criticised for using the term "guarantee" which, as has
been explained earlier, would entail the problem of treating the bank's
obligation to pay as secondary obligation.

The diversity in the nomenclature of these instruments indicates that,
terminologically and conceptually, the entire area of these commercial devices
is marked by confusion, uncertainty and inconsistency. Therefore there is a
need now more than ever for consistency in terminology. Such a consistency
without doubt would have a very significant impact in sorting out the current
confusion in dealing with these instruments. It is suggested therefore that
using such a term as "letters of guarantee" in referring to these instruments in
general would appear to be recommended for two reasons: first, this term suits
the nature and the function of these instruments, as being an independent
undertaking by the bank which takes the form of a letter by the bank to the
beneficiary promising him to pay upon his proper demand; second, the use of
the term "letter of guarantee" has the advantage of covering all types of letters
of guarantee as, for example, the tender, performance, advance payment,
maintenance payment letters of guarantee. An analogy in this respect can be
drawn with the well-known term "letters of credit" in international trade
which is used to include: revocable, irrevocable, confirmed, unconfirmed,
back to back and revolving letters of credit. It may be also added that the term
letter of guarantee is not alien to the English courts. This term has been used
by Gildwell L.J. in the case of Esal (Commodities) Ltd and Reltor Ltd v.
Oriental Credit and Wells Fargo Bank NA.\textsuperscript{37} In this case the learned judge
said:

\textsuperscript{37} [1985] 2 Lloyd's Rep. 546.
"For my part I would like to leave open for decision on some future occasion the question whether it is necessary for a beneficiary to give express notice to the bank that the qualifying event has occurred. In the instant case the demand made reference to the date, number and value of the letter of guarantee." 38

The use of this term is believed to bridge the gap in terminology between the European and the American banking practice with regard to these instruments. In this respect Kozolchyk says:

"[A] term such as 'guarantee letter of credit' may well solve the nomenclature dispute between European and American bankers and banking lawyers." 39

The inconsistency in terminology has led to the Working Group of the United Nations Commission on International Trade Law (UNCITRAL) in its draft on independent guarantees and standby letters of credit (the Uncitral Convention) to adopt the term "guarantee letter" as a generic term to cover the independent bank guarantees. The working Group agreed at its eighteenth session that, if the current approach of largely common provisions was retained, the use of one expression was useful from a drafting point of view. 40

There is no statutory definition of letters of guarantee in the United Kingdom. The Uniform Rules for "Contract Guarantees" (URCG) avoid giving a definition that covers all types of letters of guarantee. They instead give a separate definition of each of the letters of guarantee they regulate. Art.2(a) of the rules defines the "tender guarantee" as:

38 Ibid. at p.556; See also Astilleros Espanoles v. Bank of America [1995] 2 Lloyds Rep. at p.353


"an undertaking given by a bank, insurance company or other party ("the guarantor") at the request of a tender ("the principal") or given on the instructions of a bank, insurance company, or other party so requested by the principal ("instructing party") to a party inviting tenders ("the beneficiary") whereby the guarantor undertakes - in the event of default by the principal in the obligations resulting from the submission of the tender - to make payment to the beneficiary within the limits of a stated sum of money."

The performance letter of guarantee is defined by Art.2(b) as:

"undertaking given by a bank, insurance company or other party ("the guarantor") at the request of a supplier of goods or services or other contractor ("the principal") or given on the instructions of a bank, insurance company, or other party so requested by the principal ("the instructing party") to a buyer or to an employer ("the beneficiary") whereby the guarantor undertakes - in the event of default by the principal in due performance of the terms of a contract between the principal and the beneficiary ("the contract") to make payment to the beneficiary within the limits of a stated sum of money or, if the guarantee so provides, at the guarantor's option, to arrange for performance of the contract."

And finally, the repayment letter of guarantee is defined by Art.2(c) as the following:

"an undertaking by a bank, insurance company or other party ("the guarantor") at the request of a supplier of goods or services or other contractor ("the principal") or given on the instructions of a bank, insurance company or other party so requested by the principal ("the instructing party") to a buyer or to an employer ("the beneficiary") whereby the guarantor undertakes - in the event of default by the principal to repay in accordance with the terms and conditions of a contract between the principal and the beneficiary ("the contract") any sum or sums advanced or paid by the beneficiary to the principal and not otherwise repaid - to make payment to the beneficiary within the limits of a stated sum of money."
On the other hand Art.(2) of the ICC Uniform Rules for "Demand Guarantees" (URDG) defines the on demand letter of guarantee as:

"(a)...any guarantee, bond or other payment undertaking, however named or described, by a bank, insurance company or other body or person (hereinafter called the "Guarantor") given in writing for the payment of money on presentation in conformity with the terms of the undertaking of a written demand for payment and such other document(s) (for example, a certificate by an architect or engineer, a judgment or an arbitral award) as may be specified in the Guarantee, such undertaking being given

(i) at the request or on the instructions and under the liability of a party (hereinafter called the "Principal"); or

(ii) at the request or on the instructions and under the liability of a bank, insurance company or any other body or person (hereinafter "the instructing party") acting on the instructions of a Principal to another party (hereinafter "the Beneficiary").

All the above mentioned definitions indicate that it is difficult to give a precise definition that covers all types of letters of guarantee due to the fact that they are issued in many types in international and domestic transactions.

However, several attempts to give a general definition to the letters of guarantee have been made by a number of legal writers. Edwards for example suggests the following definition:

"An undertaking given by a bank, insurance company or other party ('the guarantor') at the request of a tenderer or contractor (usually referred to as the 'beneficiary') whereby the guarantor undertakes in the event of default by the principal in the performance of his obligations to the beneficiary a stated sum of money or if the contract so provide, to arrange for the performance of the relevant obligations under the tender or contract".41
Another definition, suggested by Professor Goode, reads as the following:

"An undertaking given for payment of a stated or maximum sum of money on presentation to the party giving the undertaking of a demand for payment (almost invariably required to be in writing) and such other documents (if any) as may be specified in the guarantee within the period and in conformity with the other conditions of the guarantee."\(^{42}\)

Both definitions can be criticised on the basis that they ignore the most significant characteristics of the letter of guarantee, being independent of the underlying transaction between the parties and that the bank is obliged to pay regardless of any contestation by the account party. Accordingly the following definition is suggested as a comprehensive definition that could in principle apply to the different types of letters of guarantee:

"An independent written undertaking issued by a bank, insurance company or other party (the guarantor) upon the request of its customer (the account party) with reference to a certain transaction, according to which the guarantor undertakes to pay upon the proper demand of a third party (the beneficiary) and in accordance with the letters of guarantee terms and conditions a stated or a maximum sum of money during a limited or unlimited period of time and regardless of any contestation by the account party".

This definition is believed to comply with the significant characteristics of the letter of guarantee as being independent undertaking from other relationships and from the underlying transaction between the parties and regardless of any contestation by the account party. It also emphasises the significance of the presentation of a proper demand by the beneficiary which complies with the terms and the conditions of the letter of guarantee.


2.3 Sources Of Law

The law and practice of letters of guarantee come from several primary sources. Firstly, they derive from general principles of the law of contract from which the legal rules relating specifically to letters of guarantee have been developed and to which reference must be made so as to answer any problem which has not yet been resolved by the courts. Secondly, there are the decisions of the courts which specifically relate to letters of guarantee, and the rules laid down in such decisions. As far as English case law on letters of guarantee is concerned, it can be noted that the number of the reported cases on letters of guarantee is relatively small. This may be attributed to the fact that most of the disputes related to letters of guarantee are resolved amicably between the parties involved. Thirdly, banking practice is to be considered another source relating to the letter of guarantee. In domestic and international banking transactions letters of guarantee are governed and regulated basically by banking practice.

In some countries letters of guarantee are regulated by statutory provisions of a general nature. In England, no specific legislation or regulation exists on letters of guarantee. English banking practice also shows no standard forms of letters of guarantee adopted by the English banks. It is believed that a standard form of letters of guarantee between the English banks would help to stabilise the practice of letters of guarantee.

Major advances in uniformity were to be achieved gradually by the International Chamber of Commerce (ICC), a private organisation founded in 1919 to serve the international business community. The ICC attempted to

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43 Bertrams R., Bank Guarantees in International Trade, (1996) at p.27 where he cites some countries in the Middle East as Saudi Arabia and Iraq as an example of the countries where letters of guarantee are regulated by special legislations and regulations.
standarise the relevant practice at an international level in order to draw up clear and acceptable guidelines for all those involved in letters of guarantee in business. The result was the promulgation of the Uniform Rules for Contract Guarantee (URCG), ICC Publication No. 325 in 1978. These rules sought to deal with the problem of the unfair calling in of letters of guarantee by requiring, as a condition of the beneficiary's right to payment, the production of a judgement or arbitral award or the account party's written approval of the claim and its amount. Art.(3) of the rules provides:

"A claim shall not be honoured unless:

It is supported by such documentation as is specified in the guarantee or in these Rules;..."

Art.9 of the same rules also provides:

"If a guarantee does not specify the documentation to be produced in support of a claim or merely specifies only a statement of claim by the beneficiary, the beneficiary must submit:

b...either a court decision or an arbitral award justifying the claim, or the approval of the principal in writing to the claim and the amount to be paid."

In practice this requirement contributed to limiting the acceptability of these rules where the beneficiaries considered the requirement of producing a judgement or arbitral award to establish the default of the account party as an obstacle which defeated the objective of the letters of guarantee in providing the beneficiary with speedy payment.44

As a result of the unpopularity of the URCG the International Chamber of Commerce has promulgated the Uniform Rules of Demand Guarantees (URDG) Publication No.458 in 1992 to regulate the on-demand letters of guarantee. Despite the presence of these rules, the URCG have not been withdrawn from use by the ICC and are still available for incorporation into the letter of guarantee. The URDG were intended to meet the beneficiaries' desires for a speedy payment where according to the rules the letter of guarantee is payable on first written demand, with or without supporting documents. Art. 20 (a) of the rules provides:

"Any demand for payment under the Guarantee shall be in writing and shall (in addition to such other documents as may be specified in the Guarantee) be supported by a written statement (whether in the demand itself or in a separate document or documents accompanying the demand and referred to in it) stating:

(i) that the Principal is in breach of his obligation(s) under the underlying contract(s) or, in the case of a tender guarantee, the tender conditions; and

(ii) the respect in which the Principal is in breach."

It seems that despite the ICC's high expectations of a wide acceptance of the URDG these rules have not yet gained the targeted degree of acceptance. Bertrams attributes this to "the fear that the URDG might conflict with the standard guarantee text which banks employ or the particular provisions which banks and beneficiaries wish to include or exclude." He continues "this fear is totally unjustified since the URDG themselves do not contain guarantee texts or specific provisions. Moreover, any of the Rules can be


46 Bertrams R., supra, at p.23.
excluded or modified by contractual clauses in the guarantee as agreed by the parties thereto."\textsuperscript{47} It is suggested that the other reason for the unpopularity of the URDG might be the requirement of the rules for a written demand by the beneficiary who needs to state that the account party is in breach of his obligation(s) under the underlying contract(s) and the respect in which the account party is in breach.\textsuperscript{48} The presence of this condition has provoked the banks' objections that the application of the URDG depends on the beneficiaries' acceptance rather than on the issuers' intentions. In other words the application of these rules entails that the mechanism of payment under the letter of guarantee depends solely on the beneficiary's written demand for payment that is supported by a specific statement of default, whereas these banks are accustomed to issuing simple demand guarantees. The requirement of the beneficiary's justification might lead the bank to be involved in the underlying transaction of the parties so as to verify the beneficiary's allegation(s) of the account party's default. This clearly contradicts the purpose of the rules to establish a letter of guarantee that is payable solely by the beneficiary's simple demand. This difficulty however may be overcome by virtue of Art. 20(c) which allows the parties to exclude the application of the condition of a written demand as stated by Art. 20(a) of the same rules. This article provides:

"Paragraph (a) of this Article applies except to the extent that it is expressly excluded by the terms of the Guarantee."

The application of the ICC rules to the letters of guarantee raises the question of the legal nature of these rules. Courts and commentators are not unanimous.

\textsuperscript{47} Ibid.

\textsuperscript{48} Art. 20(a) of the URDG.
on the legal nature of the ICC rules on letters of guarantee. Whereas there is a basic agreement that the ICC rules do not form part of the law of any country, there is much controversy as to whether it is an encoding of the law on letters of guarantee, or evidence of customary practices, or only "consensual regulations" relating to letters of guarantee. There is also controversy over the question of whether the individual provisions of the ICC rules have the same legal quality, that is, whether they are equally binding on all users of letters of guarantee. Further, there is a debate on the rules of construction to be applied to the ICC when its provisions are the subject of litigation. The following discussion highlights the diversity of opinion on these points.

At one extreme, the ICC rules are seen as a set of unilateral provisions drawn up by bankers and therefore without the force of law, they have not been agreed upon by all users. At the other extreme, the ICC rules are viewed as part of the lex mercatoria, as a "system if not autonomous then at least specific of legal rules demanding uniform interpretation and application on an international level". It is suggested that in the final analysis, the prevailing view is that the legal status of the ICC rules can be definitively determined in relation to a particular jurisdiction.

English law does not accord the ICC rules the status of a code or part of the lex mercatoria, yet elevates them above the position of mere rules without application unless specifically incorporated. They are regarded as evidence of banking custom or at least prevailing practice. It has been

49 e.g., M. Golodetz & Co. v. Czarnikow Rioda Co. [1980] 1 W.L.R. 495.
50 De Rooy F.P., Documentary Credits (1984) at p.16.
argued that in fact, the ICC rules may be regarded as being "directly incorporated by implication into the contract", it being the natural course that they be so incorporated.53 In the final analysis, the ICC in English law constitutes a set of contractual terms which are subordinate to legislation. As such, the terms may expressly be varied or contradicted and are subject to the courts' powers of interpretation and enforcement.54

The last issue is whether the ICC rules should be enforced in the same way on all parties associated with the letters of guarantee, i.e. banks, applicants and beneficiaries. Banks usually have a clear understanding of the ICC rules and letters of guarantee in general. Other parties rarely have such expertise and often rely on bank guidance and protection.55 It is therefore argued that between banks, the ICC rules should simply be considered an international code, while in contentions involving non-bank parties consideration should be given to notice and awareness of the ICC rules and the advice given by banks.56 This argument is plausible, but is in some ways unrealistic and may lead to undesirable non-uniform use and development of letters of guarantee law. In practice, most letters of guarantee are used by large firms well aware of letter of guarantee principles, at least with adequate legal advice. Further, making the practice of this mercantile specialty conditional on the knowledge of the user or equitable notions is to signal its destruction. It is submitted that lax standards should in no way be condoned, as the ultimate cost to the letter of guarantee instrument outweighs the merits

52 e.g., Malas (Hamzeh) & Sons v. British Imex Industries Ltd., [1958] 2 Q.B. 127 at p.129.
54 Ibid.
56 Ibid.

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of an individual case. A non-bank party that suffers loss due to advice given by a bank may seek redress for detrimental reliance or breach of the bank's duty. The force of the ICC rules should not depend on the users in a particular case. This situation is not compatible with the harmony which is sought by the ICC rules.

In the United States, standby letters of credit serve the same function as the independent letters of guarantee. They have been extensively used in the United States by the American banks because of the limited powers of these banks, under the National Bank Act, to issue guarantees. They are issued to secure the performance by the customer of an obligation owed to the beneficiary. In many cases standby letters of credit were issued as a substitute for performance letters of guarantee. And as in the case of the letter of guarantee, the essential characteristic of a standby letter of credit is that it is independent of the underlying contract, i.e. it pays against provision of documents, such as a certificate of default, and does not require the issuer to examine whether or not there has actually been a default under the underlying contract. Therefore, in substance stand-by letters of credit perform the same role as on demand letters of guarantee. In this regard Professor Goode says that:

"It is sometimes mistakenly supposed that the standby credit is different legal animal from the demand guarantee. This is not the case; in law the two forms of payment undertaking are synonymous the differences between them are of terminology and business usage".

However, despite their similarities with the letters of guarantee, standby letters of credit are governed by a different set of rules. In the United States, for example, all of the fifty American States have adopted Article 5 of the Uniform Commercial Code (UCC) to regulate standby letters of credit issues where they are not issued subject to the Uniform Customs and Practice for Documentary Credits (UCP) ICC Publication 500.\(^6\) The URDG have excluded standby letters of guarantee from being subject to its provisions. In the introduction to these rules, the drafters admitted that standby letters of credit are "technically" within the definition of the URDG. However, they expected that issuers of standby letters of credit would continue to use the UCP, which are, according to their point of view, both more detailed and more appropriate to the particular requirements of standby letters of credit.\(^6\)

The ICC official explanation for treating them separately is that:

"Standby credits are already governed by the Uniform Customs and Practice for Documentary Credits (UCP). They have developed into all purpose financial support instruments which are used in a much wider range of financial and commercial activity that demand guarantees, and regularly involve practices and procedures (e.g. confirmation, issue for a bank's own account, presentation of documents to a party other than the issuer) that are infrequently encountered in relation to demand guarantees and that ally standby credits more closely with documentary credits. Accordingly, while standby credit will continue to use the UCP, which are both more detailed and more appropriate to the particular requirements of standby credits."\(^6\)

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\(^6\) These Rules came into effect on January 1, 1994, replacing the 1983 Revision. See Article (1) of the (UCP) rules. ICC Rules for Demand Guarantee also state that "A third form of guarantee, the stand-by letter of credit, continues to be governed by the Uniform Customs and Practice for Documentary Credits.

\(^6\) See the URDG, introduction, ICC Publication No.458 at p.4.
This approach has been criticised by Professor Goode on the ground that "any formal exclusion of standby credits from the URDG would merely cause confusion, since a standby credit meets in every particular the definition of demand guarantee".63

Motivated by a similar approach, the United Commission on International Trade Law (UNCITRAL) established a Working Group on International Contract in 1995 which completed its task by drafting a convention on Independent Guarantees and Standby Letters of Credit (Uncitral Convention) which is to become effective after the signatory of five countries within two years of the General Assembly's adoption of the Convention.64 Despite the significance of the Convention in establishing uniform rules for governing the letters of guarantee and standby letters of credit, the need for the Convention has been questioned by Gorton65 on the ground that "the UCP have been successful in respect of standby letters of credit. URCG 1978, on the other hand, have not been very much applied, and the URDG 1992 have not existed for a sufficiently long enough time in order that an evaluation can be made".66

Gorton's view appears to ignore the unpopularity of both the URCG and URDG in international banking practice. It may be also added that, based on its legislative nature and its potential to supersede national legislative and

62 Ibid.
66 Ibid.
administrative norms, the Convention offers the possibility of achieving uniformity in practice.

The fundamental similarity of international demand guarantees and standby letters has been recently recognised by the American Office of the Comptroller of the Currency (OCC). According to the revised Interpretive Ruling 7.7016 which became effective in April 1, 1996 the US national banks are now allowed to issue - in addition to letters of credit - "independent undertakings" to pay against documents. The OCC defined "independent undertakings" as including not only letters of credit, both commercial and standby, but similar types of documents that are widely used in "international trade". Accordingly the revised Interpretive Ruling makes clear that US national banks may issue credits in the form of international letters of guarantee as well as in the form of standby letters of credit. In the light of the similarities between letters of guarantee and standby letters of credit in the international trade and based on the recent development in field of the standby letters of credit it is suggested that the need for uniform rules that govern both instruments in the field of the international trade appears to be more significant than ever before.

2.4 Letters of Guarantee Classification.

2.4.1 Direct and Indirect Letters of Guarantee

Generally speaking, in a domestic commercial transaction, a letter of guarantee is issued directly by the account party's bank to the beneficiary who usually carries on business in the same country. Because such three-party letters of guarantee are issued directly by the account party's bank, they are known as direct letters of guarantee. In this case the legal relationship

between the parties exists by way of three separate and independent contracts. The following example may illustrate the way these letters of guarantee are issued. It occurs when [A] and [B], for example, enter into a contractual relationship whereby [A] undertakes to build a shopping complex for [B] under which [A] also undertakes to complete the project within three years. To secure a good performance under the underlying relationship [B] normally asks for a performance letter of guarantee to be issued by the bank of [A] to his benefit. Clearly under this direct letter of guarantee three contractual relationships are established. First is the underlying contractual relationship between [A] and [B] according to which the letter of guarantee was issued. Second the relationship between the bank and the beneficiary which is embodied in the form of a direct letter of guarantee. Third an undertaking by the account party to reimburse the bank for any money it might be required to pay to the beneficiary as a result of the letter of guarantee. This contractual relationship is known as indemnity under English law.

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68 See e.g., Insurance Co. v. Heritage Bank, N.A., 595 F.2d 171, 173 (3rd Cir. 1979).

Figure 1

[Diagram showing relationships between Account Party, Beneficiary, and Bank with contracts 1, 2, and 3]
Not infrequently buyers insist on obtaining a letter of guarantee issued by a bank in their own country. Such insistence is justified on the ground that "if the letter of guarantee is called upon by the beneficiary its payment cannot be blocked or forestalled so easily by the account party (the exporter), nor will the letter of guarantee be in jeopardy in the event of hostilities arising between the importer's country and the exporter's. "Moreover, at a purely legal level no problems of international law should arise since the letter of guarantee is made between nationals of the same country".70 In such a situation the exporter (contractor) normally asks his own bank in his country to arrange for an indirect letter of guarantee. The exporter's bank (instructing bank) mandates another bank in the importer's country (issuing bank) to issue the required letter of guarantee. At the same time, the instructing bank has to offer a security to cover the risks of the issuing bank being repaid in the event that the letter of guarantee is called by the beneficiary. This security also takes the form of a letter of guarantee (counter letter of guarantee) or a standby letter of credit.

The way in which indirect letters of guarantee operate in international trade can be illustrated by the following example. It occurs when [A], an English construction company, enters into a contractual relationship with [B] another company in Kuwait for the construction of an Airport in Kuwait. In normal practice [B] will ask for a letter of guarantee to be issued to his benefit by a bank in Kuwait. [A] in this case will resort to his bank in London so as to instruct its correspondent bank in Kuwait to issue the required letter of guarantee. But before it can proceed with its client's instructions the English

bank will ask for an indemnity to be furnished by the latter. Again, this form of letters of guarantee is based on the following contractual relationships.

First the underlying contract between the account party and the beneficiary. Second, the letter of guarantee by the Kuwaiti bank to the benefit of the Kuwaiti beneficiary. Third, a counter letter of guarantee issued by the English bank to the benefit of the Kuwaiti bank undertaking to pay any sum of money the latter may have to pay to the beneficiary under the letter of guarantee. Fourth, an indemnity by the account party to the English bank in which he undertakes to pay any sum of money the latter may be required to pay to the Kuwaiti bank according to their counter letter of guarantee.

**Figure 2**

Diagram of contractual relationships involving banks.
2.4.2 CONDITIONAL AND UNCONDITIONAL LETTERS OF GUARANTEE.

In its direct or indirect form a letter of guarantee can be issued either in first demand or conditional form. The form according to which the letter of guarantee has been issued can be determined by the precise wording of the letter of guarantee itself. If the letter of guarantee is issued in a first demand form (known to many bankers as the "suicide form") this would mean that the bank's obligation to pay arises on simple demand by the beneficiary and without proof or conditions. Accordingly the beneficiary under this form has the right to call on the letter of guarantee without proof of loss caused by breach of the underlying contract, or any other form of breach.\textsuperscript{71}

These types of letters of guarantee are preferred by the beneficiaries because they provide an instrument which secures a prompt payment that is triggered by the beneficiaries' simple demand. They are also preferred by the banks as they enable them to stand clear of any contractual dispute which may arise between the parties to the underlying contract.

2.4.2.[a] Conditional Letters of Guarantee

In the case of a conditional letter of guarantee the bank's obligation to pay is conditional upon the beneficiary's proof of the account party's default in performing his obligations in accordance with the underlying transaction. The account party's default may be proved by an arbitration award or judgment against the account party or by a certificate by an independent third party such as an engineer or a surveyor. Accordingly the bank is required to determine whether the breach in question is sufficient to enable it to make payment to the beneficiary under the terms of the letter of guarantee regardless to the fact

that the account party is in default under underlying transaction according to which the letter of guarantee was issued. The insertion of a clause which requires proof of the account party's default is considered as a regular practice among the English banks. Such a clause is known as \textit{conclusive evidence} whereby it was agreed that any demand under the letter of guarantee would, as between the bank and the sellers, be conclusive evidence that the sum stated in the demand was properly due and payable. It follows that once payment was effected the account party would be unable to resist the bank's claim for reimbursement.\footnote{Goldsmith E., "Performance Bonds In English Courts", supra, at p.152.}

\section*{2.4.2[b] UNCONDITIONAL LETTERS OF GUARANTEE}

Unlike conditional letters of guarantee, the bank in a first demand letter of guarantee is not concerned with the account party's default at all. Under unconditional letters of guarantee the obligation of the bank is triggered simply upon the beneficiary's demand of letter of guarantee. In the English banking practice these letters of guarantee are known as 'first demand' or 'on-demand' letters of guarantee. They are payable without proof or condition. For example, in the case of \textit{Howe Richardson Co. v. Polimex}\footnote{\textit{[1978]} 1 Lloyd's Rep. p161.} the bank made the following undertaking in its letter of guarantee:

"In this connection we, the undersigned, below agree to give the guarantee for the refund of the advance payment amounting to twenty five thousand pounds sterling in favour of \textit{[the beneficiaries]} on their first demand in case of non delivery of the ordered goods".\footnote{Ibid, at p. 163.}
Another form of on-demand letters of guarantee has been dealt with in the case Edward Owen v. Barclays Bank International\textsuperscript{75} where the bank issued an on-demand letter of guarantee using the following wording:

"Considering the fact that the contract relating to this transaction calls for the issue of a bank guarantee for an amount of .... We, the undersigned, guarantee to you the firm 'Edward Owen' to the extent of the above mentioned amount and it is understood that the said amount will be paid on your first demand".\textsuperscript{76}

Banks prefer to issue this type of letter of guarantee since they can avoid any contractual dispute between the parties by simply paying "on demand" as the letter of guarantee requires.\textsuperscript{77} According to these types of letters of guarantee, the bank is obliged to pay when it simply receives either a demand to pay or a demand supported by a specified document, which is usually referred to as a 'documentary first demand'. Such letters of guarantee are covered by ICC Rules No. 458. The Rules state the following:

"It is a characteristic of all guarantees within these rules that they are payable on presentation of one or more documents. The documentary requirements specified in demand guarantees vary widely. At one end is the guarantee which is payable on simple written demand, without a statement of default or other documentary requirements. At the other end is the guarantee which is payable on simple written demand which requires presentation of a judgment or arbitral award. Between these two extremes lie various intermediate forms of guarantee, such as guarantees requiring a statement of default by the beneficiary, with or without an indication of

\textsuperscript{75} [1978] 1 All ER 976.

\textsuperscript{76} Ibid. at p. 980.

\textsuperscript{77} The URDG recognise this by stating that "Demand guarantees differ from documentary guarantees in that they are properly invoked only if the principal has made a default".
the nature of the default, or the beneficiary, or the presentation of a certificate by an engineer or surveyor. All these fall within the scope of the new rules." 78

In practice, unconditional letters of guarantee are also more desirable to the beneficiaries than conditional letters of guarantee as they enable them a prompt payment that is triggered by their simple demand.79

2.5 TYPES OF LETTERS OF GUARANTEE

Letters of guarantee could be classified generally by reference to the stage or segment of performance they are designed to secure.80 Commercial practice and the need to cover several types of risks all through the life of the contract were the reasons behind establishing several types of letters of guarantee.

Each type of letter of guarantee is used to cover a certain sort of risk. In practice it is very common to ask for more than one type of guarantee to secure the performance of the same underlying contract. The obligation of the bank differs according to each type of letter of guarantee. Some of these types are: tender letters of guarantee, performance letters of guarantee, advance payment letters of guarantee, retention letters of guarantee, maintenance letters of guarantee.81

2.5.1 Tender Letters Of Guarantee

Buyers are usually very keen to have the risks of non-completion of the seller's obligations that may exist between bidding for a contract until its completion covered by a letter of guarantee issued by a trustworthy bank that

78 See Penn G., & Shea A., & Arora A., The Law and Practice of International Banking, supra, at p.271 where the authors suggest that "Perhaps it is now time to alter the terminology and classify bonds as either "documentary" i.e. triggered solely by the presentation of documents" or "non-documentary".


81 Blau W., & Jedzig J., "Bank Guarantees to Pay upon First Written Demand in German Courts" [1989] 23 International Lawyer 725.
satisfies the buyers' desires of being secured against such types of risks. They usually cover 2% to 5% of the contract value and frequently remain valid for three months after the closing of bids. The purpose of a tender letter of guarantee, or "bid bond" as known by the English banks, is to indicate to the buyer that the tender is a serious offer and that the party submitting it will sign the contract if the tender is accepted. It also gives an indication to the buyer that the seller is financially competent to enter into the undertaking. Finally, it is an indication to the buyer that, on award of the contract, a subsequent letter of guarantee to secure performance and/or advance payment will be forthcoming. It may be also considered as a compensation to the buyer for any additional costs he might bear in case he needs to award the contract to another party if the seller refuses to sign the contract.82 Once the tender has been accepted, and assuming that the customer is willing to proceed, it will normally be necessary to replace the bid or tender letter of guarantee with a suitable performance letter of guarantee.83 The tender letter of guarantee should be returned to the tenderer when the principal contract is signed and a suitable performance letter of guarantee is issued.84

2.5.2 Performance Letters Of Guarantee

Performance letters of guarantee are the most common type of letters of guarantee. They are usually issued if the buyer has concerns over the seller's capability to fulfill his obligations in accordance with the underlying contract.85 It would be normal for this type of letter of guarantee to be issued

83 Ibid. at p.263.
84 Penn G. & Shea A. & Arora A., The Law and Practice of International Banking, supra, at p.263
85 Ibid.
within a specific period of time agreed between the parties and to replace any
tender letter of guarantee which has been issued in connection with the same
contract. It usually continues to be valid until the obligations of the underlying
contract are satisfactorily accomplished. If the seller fails to meet his
obligations, the buyer will simply make demand on the letter of guarantee
regardless of the terms that have been agreed upon between the parties.\(^\text{86}\)

### 2.5.3 Advance Payment Letters Of Guarantee

Construction contracts sometimes provide for an advance payment to
be paid to the contractor in order to enable him to start performing his
obligations in accordance with the underlying contract. The risk managed by
this type of letter of guarantee is the contractor's failure to earn the whole of
the advance payment by providing services to an equivalent value.\(^\text{87}\) It is
common for these letters of guarantee to contain a reducing liability clause
under the terms of which the letter of guarantee liability reduces in line either
with the delivery of goods, as evidenced by shipping documents, or by the
completion of work on site, as evidenced by specified completion
certificates.\(^\text{88}\)

### 2.5.4 Retention Letters Of Guarantee

Some construction contracts provide for a percentage of each payment
to be withheld until the project has been completed and accepted by the
contractor. This type of letter of guarantee enables the employer to receive the
total amount of each payment while assuring the contractor of a refund of
released retention moneys in the event of subsequent non-performance. The

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\(^{86}\) R.D. Harrbottle (Mercantile) Ltd. v. National Westminster Bank Ltd., [1977] 2 All E.R. 862 is an example of the such type of letters of guarantee.

\(^{87}\) e.g. Gulf Bank v Mitsubishi [1994] 2 Lloyd's Rep. 145 at p.149.

\(^{88}\) Penn G & Shea A. & Arora A., supra, at p.265
bank's obligation to pay, for example, is triggered by the contractor's demand based on the employer's default in executing the final stage of the project. In this case the bank is required to ask for proof, such as an engineer's or consultant's report, to make sure of the employer's default. This type of letter of guarantee provides the advantage of helping the employer to obtain a quick payment of the retained instalments instead of waiting for a long time.\textsuperscript{89}

### 2.5.5 Maintenance Letters Of Guarantee

Maintenance or warranty letters of guarantee are also very common in construction contracts. They are issued by the bank upon the employer's request to secure proper fulfillment of his maintenance obligations until the end of the maintenance period. Under such letters of guarantee the bank may undertake, for example, to pay upon the employer's failure to do the proper maintenance for the "air conditioning" system of the project during the designated maintenance period.

In general, due to their flexibility, letters of guarantee can be used to cover all sorts of risks, in addition to those examined above. For example, a letter of guarantee could ensure the re-exportation of the goods which were used at exhibition in another country. These types of letters of guarantee are issued in favour of the Customs in that country. Under this type of letter of guarantee, the bank undertakes to pay to the Custom's Department the amount of the letter of guarantee if the account party fails either to take his goods out when the exhibition is finished or pay the custom's duty if necessary. Letters of guarantee can be also used in connection with missing or defective documents relating to the sale and shipment of goods. For example, a buyer who is not yet in possession of the pertinent documents, such as the bill of

\textsuperscript{89} Bertrams R., Bank Guarantees in International Trade, supra, at p.30.
lading or delivery order, might be able to persuade the carrier or warehouse owner to release the goods in return for a bank letter of guarantee.

2.6 Parties To The Letter Of Guarantee

When a bank issues a letter of guarantee, several independent legal relationships between the parties to the letter of guarantee are created. The number of these relationships depends on whether or not the correspondent bank in the beneficiary's country is involved. Normally these legal relationships can be classified as:

(a) bank-account party relationship,
(b) bank-beneficiary relationship;
(c) instructing bank-issuing bank relationship.

The URCG, URDG and the UCP do not give a definition of the parties involved in a letter of guarantee or the standby letter of credit relationship. These terms were referred to indirectly by Art. 2(i) of the URDG where it provides:

"....such undertaking being given (i) at the request or on the instructions and under the liability of a party (hereinafter called "the principal"); or (ii) at the request or on the instructions and under the liability of a bank, insurance company or any other body or person (hereinafter "the instructing party") acting on the instructions of Principal to another party (hereinafter "the Beneficiary")."

Article 2(c) of the same rules defines the "counter-guarantee" as the following:

"For the purposes of these Rules "Counter-Guarantee" means any guarantee, bond or other payment undertaking of the instructing Party, however named or described, given in writing for the payment of money to the Guarantor on presentation in conformity with the terms of the undertaking of a written demand for payment and other documents specified in the Counter-Guarantee which appear on their
face to be in accordance with the terms of the Counter-Guarantee. Counter-Guarantees are by their nature separate transactions from the Guarantees to which they relate and from any underlying contracts or tender conditions and instructing Parties are in no way concerned with or bound by such Guarantees, contracts or tender conditions, despite the inclusion of a reference to them in the Counter-Guarantee.

On the other hand section 5-102(a)(2) of the UCC defines the applicant to the commercial and standby letters of credit as the following:

"[A] person at whose requests or for whose account a letter of credit is issued. The term includes a person who request an issuer to issue a letter of credit on behalf of another if the person making the request undertakes an obligation to reimburse the issuer."

Sub-section (3) of the same article defines the beneficiary as:

"[A] person who under the terms of a letter of credit is entitled to have its complying presentation honored."

And finally, the issuer is defined by sub-section (9) as:

"[A] bank or other person that issues a letter of credit, but does not include an individual who makes an engagement for personal, family, or household purposes."

In this thesis, the term "account party" will be used for the party who applies to a bank to issue a letter of guarantee. The term "beneficiary" will be used for the party to whom a letter of guarantee is issued to his benefit. The term "issuing bank" is used for the bank which issues the letter of guarantee and in the case of an indirect letter of guarantee is based in the "beneficiary's" country.

The term "instructing bank" is used for the bank which is normally located in the account party's country and instructs its correspondent bank in

90 See Airline Reporting Corp. v. First National Bank of Holly Hill 832 F.2d 823 (4th Cir. 1987).
the beneficiary's to issue a letter of guarantee in exchange for a counter letter of guarantee to be issued by the instructing bank.91 The counter letter of guarantee or a counter indemnity, as it is known in English banking practice, would be also required by the bank from its customer in exchange for issuing a letter of guarantee. For example, in the case of Edward Owen Engineering Ltd v. Barclays Bank International Ltd,92 Barclays Bank asked the account party (Edward Owen Engineering) to issue a counter guarantee to its benefit. The counter guarantee stated the following:

"In consideration of your producing the giving by Barclays Bank International Limited of a guarantee in the terms of the copy...attached hereto [that is the one of 15th November 1976] we agree to keep you indemnified...and we irrevocably authorise you to make any payments and comply with any demands which may be claimed or made under the said guarantee and agree that any payment which shall make shall be binding upon us and shall be accepted by us...as a conclusive evidence that you were liable to make such payment or comply with such demands."93

And in The Royal Bank of Scotland Ltd v. Dinwoodie94 the counter indemnity included the following provision:

"Therefore, we do hereby guarantee payment of all sums and relevant interest for which you are or may become liable under the said bond: and we agree to indemnify you of and from all loss, costs, damage and expense which you may sustain or incur in any manner or way in consequence of your have joined in the said bond: and we further agree to

91 e.g., Arbest Construction Co. v. First National Bank & Trust Co. of Oklahoma City 77 F.2d 581 (10th Cir. 1985).
92 [1978] 1 All ER 980.
93 Ibid. at p.982.
furnish you on demand with funds to meet all sums which you may be required to pay or in respect of the said bond and all charges relative to the same: and we declare that you shall be entitled to require from us whenever you think fit a payment or payments to account of our liability and this indemnity is a continuing and irrevocable obligation and shall apply to all sums for which you become liable under the said bond."

2.7 The Distinction Between Letters of Guarantee And Commercial Letters Of Credit.

In both English banking practice and case law, letters of guarantee have been seen as the "mirror image" of the letters of credit. This view by the English courts has been expressed in more than one occasion. In the case of Edward Owen, for example, Denning L.J. stated that:

"Performance bonds stand on a similar footing with letter of credit. The only exception against payment, according to both instruments, would be the case of clear fraud."

Under English law, on-demand letters of guarantee are closely associated with irrevocable letters of credit. In the case of Howe Richardson Scale v. Polimex-Cekop and National Westminster Bank Ltd., Roskill J. said:

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95 Ibid, at p.83.

96 Letter of Credit is defined in Black's Law Dictionary, (6th ed. 1990) at p. 904 in the following terms: "An engagement by a bank or other person made at the request of a customer that the issuer will honor drafts or other demands for payment upon compliance with the conditions specified in the credit. A credit may be either revocable or irrevocable. The engagement may be either an agreement to honor or a statement that the bank or other person is authorized to honor. U.C.C. art. 5-103. Letters of credit are intended generally to facilitate purchase and sale of goods by providing assurance to the seller of prompt payment upon compliance with specified conditions or presentation of stipulated documents without the sellers having to rely upon the solvency and good faith of the buyer."

97 [1978] 1 All ER 980.


"The bank, in principle, is in a position of a bank which has opened a confirmed irrevocable letter of credit. Whether the obligation arises under a letter of credit or under a guarantee, the obligation of a bank is to perform that which it is required to perform by that particular contract, and that obligation does not in ordinary way depend upon the correct resolution of a dispute as to the sufficiency of performance by the seller as the case may be, under the sale and purchase contract."100

This approach by the English courts raises the question of the extent to which these instruments are really similar and whether there are any differences between them.

A letter of credit is widely used in international banking practice. It is defined as:

"a promise by the 'issuer' (usually a bank),101 made at the request of a 'customer', that the issuer will honour drafts or other demands for payment made by the 'beneficiary' after the beneficiary has complied with the conditions set forth in the letter of credit."102

One of the differences between the two instruments is that, whereas the letter of credit is used to ensure that the supplier is paid, the letter of guarantee is intended to safeguard the other party against non-performance or late or defective performance by the supplier or contractor. Payment condition is also believed to be another difference between the two instruments. With the typical letter of credit the exporter will only be paid against presentation of documents in good order, typically the bill of lading, invoices and insurance policy. On the other hand, with a typical first-demand letter of guarantee no

100 Ibid. at p. 164.

101 According to U.C.C. Art. 5-103 (1) (c) an issuer may be a "bank or other person".

102 See UCC Arts. 5-103(1)(a) (d),(g); Braucher & Rieger. Introduction to Commercial Transactions 358-61 (1977) at pp.358-61; Stern M., "The Independence Role in Standby Letters of Credit": supra. at p. 218.
presentation of documents is required. For the bank's obligation to pay, a simple demand is all that is usually needed.\textsuperscript{103} Thus, in case of a letter of guarantee the bank usually bears more risk than that of a letter of credit. The presence of the bill of lading gives the issuing bank in letters of credit some sort of security. It gives the bank title to the goods and allows it to claim the goods if the customer refuses to reimburse the bank. In contrast the bank under the letter of guarantee has only one option, that is recourse against its customer, whose solvency is not guaranteed.\textsuperscript{104}

There is also a difference in the purpose of both instruments. The commercial letter of credit is used as a payment mechanism to reduce the risk of non-payment for goods sent to the buyer-applicant. The letter of guarantee, on the other hand, is issued as a security device in the nature of a guarantee to reduce the risk of non-performance of an obligation. In the letter of guarantee, the bank promises to pay if a certain event, usually contractual default, is certified to have occurred. The obligation does not have to be in connection with sale of goods. From this difference in purpose and context other consequences flow.

A commercial letter of credit is expected to be drawn upon if the underlying transaction is successfully performed. A demand for payment under the credit \textit{prima facie} means that the beneficiary has performed his part on the underlying transaction. It is therefore \textit{prima facie} justified. Further, when the bank pays under the letter of credit, this is done for, and on behalf of, the applicant. Payment constitutes the applicant's performance on the underlying contract. The position is different with the letter of guarantee. A demand for payment thereon indicates that there is something wrong in the

\textsuperscript{103} Edwards R., "The Role of Bank Guarantees in International Trade", supra, at p.284.

\textsuperscript{104} See UCC. Art. 5-114(3).
underlying transaction. As such, payment by the bank of the letter of guarantee is not a substitute performance for the applicant on the underlying transaction, but is equivalent to a realisation of security by the beneficiary.

The type and purpose of documents required to be presented to the bank before drawing on the two types of instruments also differ. Those tendered under the commercial credit show that the applicant has taken affirmative steps to fulfill his part of the contract. These documents normally represent the goods. Their possession and transfer amount to constructive possession and transfer of the goods themselves. As such, they have commercial value. The same cannot be said of documents required under letters of guarantee. First of all, they are so diverse that no standardisation can be asserted. Secondly, there are so few of them, usually a single document for each credit. What is common to them is the assertion of failure by the applicant to perform his obligation. In the usual case, the beneficiary issues the required documents; a certificate which can be drawn up certifying that the terms of the letter of guarantee have been complied with. Unlike its counterparts under commercial credits, it has no commercial value. It does not give a security interest nor can it be used to pass property in goods.

In commercial letter of credit practice, the bank will pay in exchange for documents representing the goods. As seen earlier, this gives the bank a security interest in the goods. Therefore, where the applicant becomes insolvent or is otherwise unable to take the documents, the bank can sell the goods to offset its loss. The position is different with documents tendered under letters of guarantee. They do not give the bank a security interest which can be liquidated where the applicant is unable to reimburse the bank.

On another level, the bank's expectations when it pays under the two instruments also differ. Since a demand for payment under the commercial
letter of credit *prima facie* indicates that the underlying contract has been duly performed, the bank will expect the applicant to be in good financial standing when it seeks reimbursement. On the other hand, drawing on the letter of guarantee indicates a breakdown in the underlying transaction. This often signals the financial weakness of the applicant. The latter will therefore usually resist payment by the bank, and if payment is made may not easily be able to secure reimbursement. This makes a difference in the anticipated financial positions of the applicants when the bank is called upon to pay. Because of this, it has been suggested that banks should evaluate risks of the two types of instruments differently.

A further distinction relates to the time when the obligation of the bank to pay under the instruments crystallises. Under the commercial letter of credit the bank will not be required to pay until the beneficiary presents the stipulated documents. The beneficiary on his part has no duty under the letter of credit to present the documents. Until he does so, thereby activating the letter of credit transaction, the bank's duty to pay does not arise. On the other hand, the bank's liability on the letter of guarantee becomes absolute when it is opened, therefore, without performance on any one's part, the bank's liability is established.
CHAPTER THREE

THE LEGAL NATURE OF THE BANK'S OBLIGATION TO PAY UNDER THE LETTER OF GUARANTEE.

3.1 General.

The bank's obligation to pay under the letter of guarantee starts from the moment it becomes legally involved in a letter of guarantee transaction. Before it can issue a letter of guarantee the bank normally follows a number of procedures that are fundamental to the process of issuing a letter of guarantee. The most significant characteristic of the bank's obligation to pay under the letter of guarantee is the independence of this obligation from other relationships under the guarantee. Prior to payment the bank is required to ensure whether or not the demand complies with the terms and conditions of the letter of guarantee. This chapter will be concerned with examining the circumstances under which the bank's obligation to pay is established and the bank's payment mechanism under the letter of guarantee.

3.2 The Formation Of The Letter Of Guarantee.

Most letters of guarantee are issued pursuant to an underlying contract between the beneficiary and the account party.\textsuperscript{105} The process of issuing the letter of guarantee begins when the account party instructs his bank to issue a letter of guarantee for the benefit of a certain beneficiary. A letter of guarantee comes into being as the result of a written application by the applicant who is usually the provider of the services or the contractor in construction contracts. The applications for the issuance of letters of

\textsuperscript{105} Some letters of guarantee are issued without the existence of the underlying contract as for example letters of guarantee which are issued to secure the bank client's undertaking to retrieve the goods for exhibition at an exhibition in another country.
guarantee are usually printed in a standardised form and vary from bank to bank or from one country to another. They might also vary according to the anticipated type of the letter of guarantee. The process of issuing a letter of guarantee normally starts by the applicant filling and signing an application form. Such process is deemed as a request, mandate and an indemnity by the applicant to the bank; the applicant specifies the terms of issuance and agrees to reimburse the bank and to pay the commission. The application constitutes a memorandum of the account party's instructions to the bank with the details in which it is framed. The intention is to avoid misunderstanding between the parties. It is important therefore that the application forms be drafted in precise and unambiguous language. Whereas the bank's right of reimbursement depends on its adherence to a customer's instructions, it should accordingly refuse to execute a customer's ambiguous instructions. This fact has been pointed out by Art. 3 of the URDG where it is said that the instructions to issue a letter of guarantee should be complete and precise and should avoid excessive detail. The application should specify the documents against which the bank is to fulfill its obligation of payment.

After it receives the application from the applicant, the bank starts by studying the application and discussing the letter's of guarantee proposed terms and conditions with the applicant. Such proposed terms and conditions are normally the result of the negotiations between the account party and the beneficiary in their underlying relationship. The letter of guarantee document include some details as to the type, the amount and the documents against which it is going to be payable. After a careful study of the application the bank should reach a decision either to accept or to refuse its customer's application to issue a letter of guarantee. The bank's approval or refusal to issue a letter of guarantee should be notified to the customer. The English
banks in practice are in the habit of sending a written notification to their customers informing them of their decision. Generally speaking the need for a letter of guarantee starts when the parties agree in their underlying contract that a letter of guarantee be issued by a bank within a specified period of time. It is accordingly the duty of the applicant to procure the issuing of the required letter of guarantee within the designated time and by the named bank. He must also ensure that the letter of guarantee has been notified to the beneficiary by the named bank or its correspondent within the designated time.

Letters of guarantee come into being from the date of their formation. The bank's issuance of the letter of guarantee starts from the time when its promise to issue a letter of guarantee is dispatched or transmitted to the beneficiary. It is significant for the bank, therefore, to know at what point its undertaking becomes binding so it can reach the right decision over when payment is required. When it issues a letter of guarantee, the bank makes a promise to perform its duties and obligations according to its terms and conditions. It undertakes to pay, if it receives a valid demand by the beneficiary supported by the required document(s). The problem with the relationship between the beneficiary and the bank lies in the rules of contract law under the common law. In English law, a promise, as a general rule, is not binding on the promisor if it is not supported by 'consideration'. In United City Merchants (Investments) Ltd. v. Royal Bank of Canada (The American Accord), a letter of credit case, Lord Diplock ruled that the creation of an

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106 Goode, R.. The ICC Rules for Demand Guarantees, (1993) at p.55; UCC section 5-106 provides: "(a) A letter of credit is issued and becomes enforceable according to its terms against the issuer when the issuer sends or otherwise transmits it to the person requested to advise or to the beneficiary. A letter of credit is revocable only if it so provides."

107 [1982] 2 W.L.R., 1039.
irrevocable confirmed letter of credit creates a contract between the confirming bank and the seller under which the confirming bank undertakes to pay the seller (or to accept or negotiate without recourse to drawer bills of exchange drawn by him) up to the amount of the credit against presentation of the stipulated documents. His Lordship refers specifically to the fact that the confirming bank:

"...is under a contractual obligation to the seller to honour the credit."

The problem is that the House of Lords did not attempt to discuss the legal basis of the confirming bank's contractual obligations to the seller in the light of the English contract doctrine of consideration.

Several rules have been developed under which promises not made under seal can be enforced by the promisee. These rules are compendiously known as 'the doctrine of consideration'. Consideration has been defined as: 108

"A valuable consideration, in the sense of the law may consist either in some right, interest, profit or benefit accruing to one party or some forbearance, detriment, loss or responsibility, given, suffered undertaken by the other."

The most significant aspect of the doctrine is that 'something of value' must be given for a promise in order to make it enforceable as a contract. 109 So that in a bilateral contract the consideration for each promise is said to be the promise received in return. For example, in a contract to sell a car for two thousand pounds sterling, the seller's promise to deliver the car is consideration for the buyer's promise to pay the money, and vice versa. The pre-eminent problem in letter of guarantee is to establish a satisfactory legal

basis for the relationship between the bank and the beneficiary and to find a sufficient consideration moving from the beneficiary for the undertaking contained in the letter of guarantee. However, it is difficult to see what consideration the beneficiary of the letter of guarantee provides in connection with the actual issue of the letter of guarantee. It may be argued that consideration is to be found in the fact that on the execution and presentation of the letter of guarantee required under a construction contract, the contractor was given the right and benefit of commencing work under the contract. But he was not given that right by the employer's receipt of the guarantee. It was a contractual right which he already had, and it did not lie in the hands of the employer to stop him.110

In order to be valid, the consideration furnished by the beneficiary must not be a past consideration, i.e. it should not be one arising from a previous bargain.111

Absence of consideration may lead to the bank withdrawing its obligation to pay under the letter of guarantee before the beneficiary has done anything that amounts to consideration. Under English law there are no cases in which the issue of the legal nature of the contract between the bank and the beneficiary under the letter of guarantee has been discussed. In the case of Urquhart, Lindsay & Co.Ltd. v. Eastern Bank Ltd.112 Rowlatte J. in dealing with the legal position of the parties in a confirmed letter of credit said:

"There can be no doubt that upon the undertaking contained in this letter of credit consideration moved from the


111 As to consideration generally, see Guest A.G. Chitty on Contract, supra, at pp.165-262.

112 [1922] 1 K.B. 318 at p.323.
plaintiffs which bound the defendants to the irrevocable character of the arrangement between the defendants and the plaintiffs."

The judge was thus suggesting that the contract was in fact concluded by the plaintiffs "acting upon the undertaking" and that their so acting was a sufficient acceptance of the bank's offer. This was a case involving the manufacture and shipment of certain machinery to India from Glasgow. The judge did not explain what he meant by 'acting upon the undertaking'. In the majority of cases with regard to letters of credit, no clear attempt is made to analyse the precise nature of the bank's undertaking. It is regarded as arising by business usage from an independent contract between the bank and the seller. This indeed was the view taken by the House of Lords in the American Accord case.113 But what consideration is sufficient to establish a contract between the bank and the beneficiary?

In the light of the above mentioned difficulties it seems that strict application of the doctrine of consideration would defeat the legal nature of letters of guarantee. They are irrevocable and accordingly they cannot be withdrawn without the consent of the beneficiary once it is notified to him. It may also cause some difficulties such as finding consideration which moves from the beneficiary to the bank in order to support the bank's promise to cover its obligation from the moment of issuing the letter of guarantee.114 A solution may be suggested by drawing an analogy with the case of irrevocable documentary letters of credit, where the bank's obligation to pay is considered

113 [1982] 2 W.L.R. 1039.

114 Atiyah P.S., An Introduction To The Law Of Contract, (5th cdn 1995) at pp. 65-6; e.g., Dexters Ltd v Schenker & Co. (1923) 14 L.I. Rep 586.
to be binding in law from the moment of their issuance.\textsuperscript{115} The legal basis for such solution may be a mercantile custom which makes an exception to the consideration rule in the case of letters of guarantee contracts.\textsuperscript{116} The theoretical problem of consideration under the English law does not seem to have been raised seriously in practice.\textsuperscript{117} This has led some commentators to ignore the issue of consideration as being an obstacle in the way of the formation of letters of guarantee. Jack, for example, says that "It would be surprising if a bank of any standing and reputation were prepared to repudiate its obligations under a demand guarantee on the ground that, despite the fact that the bank had happily taken its commission from the applicant (or account party), its undertaking was worth nothing because it was unsupported by consideration. It would be the more surprising if, having done so, it was prepared to face a trial and a certain place in banking journals and in the law reports." \textsuperscript{118}

The doctrine of consideration in the final analysis should not give rise to many concerns in a letter of guarantee if it is made subject to the URDG. It seems that consideration is not a pre-condition of formation of a letter of guarantee according to both URDG and Uncitral Convention. Art. 6 of the URDG provides that the letter of guarantee enters into effect as from the date of its issuance unless its terms expressly provide that it enters into effect at a later date or subject to conditions specified in the letter of guarantee and

\textsuperscript{115} Jack R., supra. at p.287.

\textsuperscript{116} e.g., \textit{Esal (Commodities) Ltd and Retlor Ltd v Oriental Credit Ltd [1985] 2 Lloyd's Rep. 546}, CA.


\textsuperscript{118} Jack R., supra. at p. 286.
decided by the bank on the basis of any documents therein stipulated. Art. 7(c) of the Uncitral Convention, on the other hand, provides that the issuance of the letter of guarantee takes place when it leaves the sphere of the bank's control; i.e. when it is issued and notified to the beneficiary by the bank. The majority of the English banks in practice notify their customer in writing of their approval of issuance of a letter of guarantee. As regards standby letters of credit, section 5-105 of the UCC expressly dispenses with the requirement of consideration as a condition of formation of the standby letter of credit. Section 5-105 of the UCC explicitly provides:

"Consideration is not required to issue, amend, transfer, or cancel a letter of credit, advice, or confirmation."

3.3. Drafting a letter of guarantee

The general rule in English law is that contracts may be formed in any way including writing, word of mouth or conduct. Letters of guarantee

119 Art. 6 of the URDG provides: "A Guarantee enters into effect as from the date of its issue unless its terms expressly provide that such entry into effect is to be at a later date or is to be subject to conditions specified in the Guarantee and determinable by the Guarantor on the basis of any documents therein specified."

120 Article 7 of Uncitral Convention provides: "(1) Issuance of an undertaking occurs when and where the undertaking leaves the sphere of control of the guarantor/issuer concerned.
(2) an undertaking may be issued in any form which preserves a complete record of the text undertaking and provides authentication of its source by generally accepted means or by a procedure agreed upon by the guarantor/issuer and the beneficiary.
(3) from the time of issuance of an undertaking, a demand for payment may be made in accordance with the terms and conditions of the undertaking, unless the undertaking stipulates a different time.
(4) an undertaking is irrevocable upon issuance, unless it stipulates that it is revocable."

121 International Encyclopedia of Comparative Law, at p.38.


123 Atiyah P.S., supra at p.155.
accordingly could also be formed in accordance with any of these methods under English law. In practice, however, the banks issue letters of guarantee in writing. Written letters of guarantee are preferred due to the fact that written terms and conditions are easier to refer to when disputes between the parties arise. Art. 2(a) of the URDG states that letters of guarantee should be issued in writing. The rules also provide that "the expressions (writing) and (written) shall include an authenticated teletransmission or tested electronic data interchange ("EDI") message equivalent thereto".124 Professor Goode states that: "the term teletransmission should be considered to include messages sent by cable (wire), telex, telefax or electronic mail. Teletransmissions include messages sent direct or through a telecommunications network (e.g. SWIFT) and messages broken up into packets of structured data and reassembled."125

The bank even after the issuance of the letter of guarantee may find itself inclined to make some amendments to the letter of guarantee terms or conditions. To be able to do so, the bank should communicate these proposed amendments to the beneficiary so that these amendments will be effective from the date of their acceptance by the beneficiary. But if they are rejected by the beneficiary the letter of guarantee will continue in force in accordance with its unamended terms. Any amendment to the letter of guarantee requires the account party's or the instructing bank's consent. Otherwise the bank would be held liable if it executes any amendment without such consent.126

124 See Art.2(d) of the URDG.


126 Bertrams R., supra, at p.170.
An amendment to the letter of guarantee may be also proposed by the beneficiary. It is necessary in this case to obtain the bank's consent to the proposed amendments. Art. 7(1) of the URCG has clearly stated that:

"A tender guarantee is valid only in respect of the original tender submitted by the principal and does not apply in the case of any amendments thereto, nor is it valid beyond the expiry date specified in the guarantee or provided for by these Rules, unless the guarantor has given notice in writing or by cable or telegram or telex to the beneficiary that the guarantee so applies or that the expiry date has been extended."

In the case of the standby letters of credit, Art. 5-106(b) of the UCC adopts a similar approach. It provides that:

"After a letter of credit is issued, rights and obligations of a beneficiary, applicant, confirmer, and issuer are not affected by an amendment or cancellation to which that person has not consented except to the extent the letter of credit provides that it is revocable or that the issuer may amend or cancel the letter of credit without that consent."

If the standby letter of credit was issued subject to the UCP it will according to Art. 9(iii) remain "in force until the Beneficiary communicates his acceptance of the amendment to the bank that advised such amendment. The Beneficiary should give notification of acceptance or rejection of the amendment(s). If the Beneficiary fails to give such notification, the tender of documents to the Nominated Bank or issuing Bank, that conform to the Credit and not yet accepted amendment(s), will be deemed to be notification of acceptance by the Beneficiary of such amendment(s) and as of that moment the Credit will be amended."

3.4 THE PRINCIPLE OF INDEPENDENCE.

A fundamental basis of letter of guarantee practice is the independence or "autonomy" of the bank's obligation contained in the letter of guarantee
from the underlying transaction and other related contracts. This is the principle of independence, also known as the abstraction of the letter of guarantee promise. It requires that the obligation of the bank be unqualified either by any disputes between the account party and beneficiary of the letter of guarantee or dependent on performance of the underlying contract by the beneficiary. Art. 2(b) of the URDG puts it thus:

"Guarantees by their nature are separate transactions from the contract(s) or tender conditions on which they may be based, and Guarantors are in no way concerned with or bound by such contract(s), or tender conditions, despite the inclusion of a reference to them in the Guarantee. The duty of a Guarantor under a Guarantee is to pay the sum or sums therein stated on the presentation of a written demand for payment and other documents specified in the Guarantee which appear on their face to be in accordance with the terms of the Guarantee."

The autonomy principle bars the bank from using its relationship with the account party to repudiate its obligation to the beneficiary. Whether it has not been put in funds to cover the letter of guarantee or otherwise has a right of set-off against the account party, it must honour the beneficiary's demand for payment if the proper demand and documents are presented.

Although letters of guarantee come into effect as a requirement of the parties underlying transaction, the banks' obligation to pay under the letter of guarantee is independent from the parties' relationship.¹²⁷ The principle of independence plays an important role in the parties' relationship by meeting their expectations that the funds of the letter of guarantee shall be promptly available to the beneficiary upon a proper demand.¹²⁸

The significance of the principle of independence also arises from the fact that it distinguishes letters of guarantee from the ordinary type of bank guarantees where the bank's obligation is secondary and can be affected by the defences arising from the underlying contract. This entails that the letter of guarantee contract should be treated as an independent transaction and should be performed independently of the performance of the underlying relationship.129

The bank's obligation to pay accordingly should not be affected by factors that are not related to the letter of guarantee contract, such as liquidation of the account party, insolvency, avoidance, rescission or repudiation of the mandate relationship between the account party. It must not also be affected by other events, as for example, not furnishing the bank with a suitable coverage for payment by the account party or by the fact of the invalidity of the underlying contract.130 The principle of independence applies

128 The terms "absolute" and "unconditional" are generally deemed to be synonymous; see Penn G., "Performance Bonds: Are bankers free from the underlying" [1985] Lloyd's Maritime Commercial Law Quarterly 132 at p.133: The significance of the independence of the letters of guarantee has been recognised by all of the ICC and Uncitral Convention rules; as to the case of standby letters of credit Art.3 (a) of the UCP provides: "Credits, by their nature, are separate transactions from the sales or other contract(s) on which they may be based and banks are in no way concerned with or bound by such contract(s), even if any reference whatsoever to such contract(s) is included in the Credit. Consequently, the undertaking of a bank to pay, accept and pay Draft(s) or negotiate and/or to fulfill any other obligation under the credit, is not subject to claims or defenses by the applicant resulting from his relationships with the issuing Bank of the Beneficiary"; see also Art. 2(1) of the Uncitral Convention which provides: "For the purpose of this convention, an undertaking is an independent commitment, known in international practice as an independent guarantee or as a standby letter of credit, given by a bank or other institution or person ("guarantor/issuer") to pay the beneficiary a certain or determinable amount upon simple demand or upon demand accompanied by other documents, in conformity with the terms and documentary conditions of the undertaking, indicating, or from which it is to be inferred, that payment is due because of a default in the performance of an obligation, or because of another contingency, or for money borrowed or advanced, or on account of any mature indebtedness undertaken by the principal/applicant or another person.". McQuiston R., "Drafting an Enforceable Guaranty in an International Financing Transaction: A Lender's Perspective" [1993] International Tax & Business Lawyer, at p.142.

similarly to the case of indirect letters of guarantee where the counter letter of guarantee is independent from the letter of guarantee document. Under this relationship the issuing bank is not allowed to raise any defence against payment that may be derived from its relationship with the instructing bank.

The Uncitral Convention has recognised the significance of the principle of independence under the letter of guarantee. According to Art. 3 of the Convention the bank's obligation to pay is to be deemed independent whereas "the guarantor/issuer's obligation to the beneficiary is not:

(a) dependent upon the existence or validity of any underlying transaction, or upon any other undertaking (including stand-by letters of credit or independent guarantees to which confirmations or counter-guarantees relate); or

(b) subject to any term or condition nor appearing in the undertaking, or to any future, uncertain act or event except presentation of documents or another such act or event within a guarantor/issuer's sphere of operations"

It is suggested that this article could be considered as a guideline to the banks in drafting their letter of guarantee document. Good drafting that explicitly emphasises the independence of the bank's obligation to pay from the underlying relationship could save the bank a lot of problems that may be related to the underlying relationship. The English courts have also emphasised the significance of the principle of independence. In the case of Howe Richardson Scale Co Ltd v. Polimex-Cekop\textsuperscript{131} Roskill L.J. said:

\textsuperscript{130} Bertrams R.. supra, at p.132; e.g., Pitcher v. Lauritzen, 423 P.2d 491; Continental Cas. Co. v. Boerger, Tex. Civ. App., 389 S.W.2d at pp.566-8; see also Art.3 of the Uncitral Convention which provides: "For the purpose of this Convention, an undertaking is independent where the guarantor/issuer's obligation to the beneficiary is not: (a) Dependent upon the existence or validity of any underlying transaction, or upon any other undertaking (including stand-by letters of credit or independent guarantees to which confirmations or counter-guarantees relate)."

"Whether the obligation arises under a letter of credit or under a guarantee, the obligation of the bank is to perform that which it is required to perform by that particular contract, and that obligation does not in the ordinary way depend on the correct resolution of a dispute as to the sufficiency of performance by the seller to the buyer or by the buyer to the seller as the case may be under the sale and purchase contract; the bank here is simply concerned to see whether the event has happened on which its obligation to pay has arisen".132

The courts considered the bank's obligation to pay under the "on-demand" letter of guarantee as primary and independent of the underlying contract.133 The court in of *Siporex Trade SA v Bank Indosuez*,134 for example, recognised the importance of the letter of guarantee as being independent of the underlying contract and held that the bank is not concerned with the underlying dispute between the account parties and the beneficiaries when it proceeds to payment. In this case Hirst J. said that

"... the whole commercial purpose of a performance bond was to provide a security which was to be readily, promptly and assuredly realisable when the prescribed event occurred; a purpose reflected in that it should be payable on first demand; the bank guarantor was not and ought not to be concerned in any way with the rights and wrongs of the underlying transaction."135

Again the importance of the principle of independence in the letter of guarantee was also recognised by the English courts in the case of *Howe Richardson Scale Co. Ltd v Polimex Cekop and National Westminster Bank Ltd.*, 136 where Roskill L.J. stated:

132 Ibid., at p.165.

133 See Penn G., "On demand Bonds Primary or Secondary Obligations?", supra, at p.225.


135 Ibid., at p. 147.


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"Whether the obligation arises under a letter of credit or under a guarantee, the obligation of the bank is to perform that which it is required to perform by that particular contract, and that particular contract, and that obligation does not in the ordinary way depend on the correct resolution of a dispute as to the sufficiency of performance by the seller to the buyer or by the buyer to the seller and purchase contract; the bank here is simply concerned to see whether the event has happened upon which its obligation to pay has arisen." 137

The independence of the bank's obligation to pay from the underlying contract entails that the bank should be allowed to honour its obligation to pay under the letter of guarantee irrespective of any disputes between the parties. This point has been emphasised in the case of Edward Owen Engineering Ltd v. Barclays Bank International Ltd 138 where Lord Denning said:

"Any dispute between buyer and seller must be settled between themselves. The bank must honour the credit. That was clearly stated in Malas (trading as Hamzeh Malas & Sons) v. British Imex Industries Ltd. 139 Jenkins LJ, giving the judgment of this court, said: '..it seems to be plain that the opening of a confirmed letter of credit constitutes a bargain between the banker and the vendor of the goods, which imposes on the banker an absolute obligation to pay, irrespective of any disputes which there may be between the parties on the question whether the goods are up to contract or not. An elaborate commercial system has been built up on the footing that bankers confirmed credits are of that character, and in my judgment, it would be wrong for this court in the present case to interfere with that established practice." 140

137 Ibid.

138 [1978] 1 All ER 976.


140 [1978] 1 All ER 976 at p. 981.
The principle of independence raises the question of the extent the bank's obligation to pay might be affected by other relationships that arise from the underlying contract, taking into consideration that most letters of guarantee exist as a requirement of the underlying contract. The principle of independence should not be construed to mean that the bank is not allowed under any circumstances to inquire into the underlying relationship of the parties. On the contrary, the bank may refer for example to the underlying relationship of the parties without being considered in violation of the principle of independence for the purpose of ensuring whether or not the demand relates to the proper underlying contract that is secured by the letter of guarantee. It is also suggested that the bank does not violate the principle of independence if it refers to the underlying contract in order to check the mechanism of payment according to which the obligation of the bank becomes effective or to check the authority of the person who is making the demand.

The need for the bank's inquiry into the underlying relationship appears to be more pressing in the case of documentary letters of guarantee where the bank is obliged to examine the demand and the documents that are presented for payment. The bank's ability to make such inquiries may be questioned as it may affect its obligation to pay as being a primary obligation. There are two points of view on this question. The first does not believe that the bank's duty of examination would have any negative impact on its obligation to pay.

141 The distinction between these two kind of obligations is believed to be of the utmost importance since in the case of a secondary obligation the bank will be under no obligation at all in the event that the principal obligation does not come about or if it has been discharged. In the case of a primary obligation the bank will be liable to make payment notwithstanding that the underlying contract never comes into being or is null and void: see Penn G., "On demand Bonds Primary or Secondary Obligations?", supra, at p.266.
The bank's obligation to pay would therefore continue to be a primary obligation even if it was forced to inquire into the underlying contract between the parties.\textsuperscript{142} The second point of view, however, believes that as letter of guarantee in fact comes into being as a requirement of the underlying relationship this would necessarily require that the bank is at liberty to invoke any defence that might be derived from the underlying relationship of the parties and would as a result convert its obligation to pay into a secondary obligation.\textsuperscript{143} The same point was also raised in the case of Siporex v. Banque Indosuez.\textsuperscript{144} In this case the beneficiaries contended that the performance letter of guarantee created an absolute obligation of payment by the bank. The account parties on their side argued that the performance letters of guarantee were not absolute. In this case Hirst J. believed that the bank's obligation to pay was absolute and that there was a need for a consistent approach by the courts towards the bank's obligation to pay under the letter of guarantee as being absolute. He said that:

"It is extremely important that, for such a frequently adopted commercial transaction, there should be a consistency of approach by the Courts, so that all parties know clearly where they stand."\textsuperscript{145}

A different approach as to the nature of the bank's obligation to pay has been taken by another court in the letter of credit case of WJ Alan & Co. Ltd v

\textsuperscript{142} In Potton Homes Ltd v Coleman [1984] 28 BLR 19 May L.J adopted the doctrine of strict autonomy of the bond and would not admit such additional defences.

\textsuperscript{143} Penn G., "On demand Bonds Primary or Secondary Obligations?", supra, at p.225.

\textsuperscript{144} [1986] 2 Lloyd's Rep. 146 at p.150.

\textsuperscript{145} Ibid. at p.158.
In this case it was said by Denning L.J. that:

"In my opinion a letter of credit is not to be regarded as absolute payment unless the seller stipulates, expressly or impliedly, that it should be so. He may do it impliedly if he stipulates for the credit to be issued by a particular banker to the exclusion of the buyer."

In the light of the above mentioned decisions it is suggested that the decision of Denning L.J. seems to be more plausible. The bank's obligation to pay under the letter of guarantee should not always construed as absolute. The nature of the bank's obligation may be decided in accordance with many factors such as the wording of the letter of guarantee, the mechanism of payment and limits of the bank's authority to inquire into the underlying contract. It seems accordingly that Hirst J. was wrong to consider the bank's obligation to pay as always being absolute merely for the sake of the consistency of the courts' decisions with regard to the letter of guarantee.

Every case should be decided on its merits. In the case of the conditional letter of guarantee, for example, the bank is under a duty to examine the accompanying documents so as to ensure that the event upon which its obligation to pay has arisen. The abstraction of the bank's obligation to pay raises the question of whether or not it contradicts the principle of independence under the letter of guarantee. The principle of independence has been seriously questioned in Potton Homes Ltd. v. Coleman Contractors (Overseas) Ltd. In this case the plaintiff supplier had agreed to supply the defendants with prefabricated building units for shipment to Libya. The plaintiff suppliers gave performance letters of guarantee for each of the two


147 Ibid. at p.159.

contracts. A dispute arose between the parties over monies owed and alleged defects in the houses that had been delivered. The defendants made a demand on the performance bonds, but the plaintiff anticipated by obtaining an interim injunction restraining the defendants from calling on the bonds. In this case Eveleigh L.J. considered how far the performance letter of guarantee could be regarded as independent of the underlying contract between the buyer and the seller. He stated that:

"while from the point of view of the bank the underlying contract is irrelevant and the bank's contract with the seller is independent of it, nonetheless as between buyer and seller the underlying contract may not be irrelevant." 149

The Court of Appeal held that the beneficiaries were entitled to obtain payment under the performance letter of guarantee, notwithstanding the fact that the parties were in dispute over the plaintiffs' claim for ninety thousand pounds sterling. May, L.J. observed that from the bank's point of view the underlying contract between the parties was irrelevant. The bank's contract with the defendants was independent of the underlying contract and, therefore, the bank was under an obligation to honour the bond when demand was made. Eveleigh L.J., suggested however that he would be prepared to grant an injunction restraining the bank from making payment under such a letter of guarantee where the seller proves (to the bank's satisfaction) that the underlying contract has been lawfully avoided or that there is a total failure of consideration on the part of the buyer. May L.J refused to let the bank depend on defences arising from the underlying contract. It seems that there is a

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149 Ibid. at p. 24.
remarkable difference of opinion in their judgments on the question of autonomy of the performance letter of guarantee.\textsuperscript{150}

The bank's right of reimbursement by the account party should not be affected by defences which the account party may have against the beneficiary on the basis of the underlying relationship. This is based on the principle of independence, which entails that the bank should effect payment to the beneficiary exclusively on the basis of the terms and conditions of the letter of guarantee, the bank accordingly does no more and nothing than carrying out its customer's instructions. If the defences of the account party against the beneficiary were to affect the bank's recourse, it would result in the bank bearing the risks emanating from the independent nature of the letter of guarantee, instead of the account party. This cannot be intended. In other words, by requesting the bank to furnish an independent letter of guarantee and by the bank's acceptance of the request of account party, the bank indicates that defences from the underlying contract are extraneous to the obligation and the right of reimbursement. Accordingly this principle of independence is necessarily implied as a matter of logic and need not to be stipulated.\textsuperscript{151}

3.5 Payment Under The Letter Of Guarantee.

3.5.1 The Demand for Payment

The bank's obligation to pay under the letter of guarantee is triggered when it receives a proper demand by the beneficiary requiring it to pay the letter of guarantee amount. Thus every letter of guarantee should include a clear mechanism of payment according to which the bank's obligation to pay

\textsuperscript{150} Penn G., "Performance bonds: are bankers free from the underlying contract?", supra, at p.134.

\textsuperscript{151} Bertrams R., supra, at pp.70-1.
becomes effective. Letters of guarantee should also set forth an acceptable form of demand according to which the bank’s obligation to pay is triggered.

The mechanism of payment is normally determined by the type, terms and conditions of the letter of guarantee. Accordingly the demand for payment could be either simple or accompanied by certain documents as specified in the letter of guarantee document. In the case of documentary letters of guarantee, the beneficiary is required to present certain documents to support his demand for payment in order to prove the account party’s default. Such documents are usually specified in the letter of guarantee contract. If one or more of these documents are not specified in the letter of guarantee a solution might be derived from Art.9 of the URCG. According to this article the beneficiary should support his demand for payment by one of the following documents:

(a) in the case of a tender letter of guarantee, he should submit a declaration that the account party has failed to sign the contract or to submit a performance letter of guarantee, although the principal’s contract has been accepted;

(b) in the case of the performance or repayment letters of guarantee, the beneficiary should submit a court decision or an arbitral award to confirm his demand, or present the account party’s approval to have the letter of guarantee paid to him.152

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152 Art.9 of the URCG provides: “If a guarantee does not specify the documentation to be produced in support of a claim or merely specifies only a statement of claim by the beneficiary, the beneficiary must submit: (a) in the case of a tender guarantee, his declaration that the principal’s tender has been accepted and that the principal has either failed to sign the contract or has failed to submit a performance guarantee as provided for in the tender, and his declaration of agreement, addressed to the principal, to have any dispute on any claim by the principal for payment to him by the beneficiary of all or part of the amount paid under the guarantee settled by a judicial or arbitral as specified in the tender documents or, if not so specified or otherwise agreed upon, by arbitration in accordance with the Rules of the ICC court of Arbitration or with the UNCITRAL Arbitration Rules, at the option of the principal; (b) in the case of a performance guarantee or of a repayment
In the case of an "on-demand" letter of guarantee the beneficiary is simply required to present a written demand asking the bank for payment. Article 20(a) of the URDG requires any demand under the "on-demand" letter of guarantee be in writing. The expressions "writing" and "written" shall include an authenticated teletransmission or tested electronic data interchange ("EDI") message equivalent thereto.\(^{153}\) In the banking practice the lack of authentication could result from the exclusion of many communications devices, for example the telefax or telephone, as being valid methods of making demand under a letter of guarantee as provided by Art. 20(a) of the URDG.\(^ {154}\) However, the parties could avoid the problem of the lack of authentication of a written demand by excluding the requirement of a written demand. They have the right to do so according to Art. 20(c) of the URDG which provides

"Paragraph (a) of this Article applies except to the extent that it is expressly excluded by the terms of the Guarantee. Paragraph (b) of this Article applies except to the extent that it is expressly excluded by the terms of the Counter-Guarantee".

The problem of authentication as a result of using these devices of communication does not appear under Art. 8(1) of the URCG where it provides that:

"A claim under a guarantee shall be made in writing or by cable or telegram or telex to be received by the guarantor not later than on the expiry dated specified in the guarantee or provided for by these Rules."

\(^{153}\) See Art. 2(d) of URDG.

\(^{154}\) Goode R., Guide To The ICC Uniform Rules for Demand Guarantees, supra, at p.47.
The UNCITRAL Convention shows more liberal approach in accepting a demand for payment using one above mentioned devices of telecommunication. According to the Convention a demand for payment could take any form as long as it secures a complete record of the text of the undertaking and could provide authentication of its source by generally accepted means or by procedure agreed upon by the bank and the beneficiary.

In the light of Art. 20(a) of the URDG it can be suggested that this article contradicts the main purpose of an on-demand letters of guarantee as being cash in hand.\(^{155}\) The requirement of the beneficiary's statement to justify his demand under the letter of guarantee as a condition of payment could be criticised on the ground that it makes the letter of guarantee solely payable upon the beneficiary's written statement of default. In this case it is the impartiality of the beneficiary that is to be questioned, taking into account that when a demand is made the relation between the beneficiary and the account party would be at its worst. This may also raise the question of the extent to which the bank could rely on the beneficiary's statement and whether it is entitled to examine the underlying transaction in order to assess the account party's default. In *Esal (Commodities) Ltd., Relitor v Oriental Credit*,\(^{156}\) it was held that the beneficiary was not required to prove the principal's default, and

\(^{155}\) Lipton J., "Uniform Regulations of Standby Letters of Credit and Other First Demand Security Investments in International Transactions" [1993] *Journal of International Banking Law*, at p.408: This Article has the potential to lessen the attractiveness of first demand security instruments for beneficiaries. If it is incorporated into a first demand security instrument, the beneficiary may well regard this as an unacceptable weakening in his position under the instrument which, to some extent, may defeat the purpose of entering into a 'pay on demand' security. It has potential to make the first demand obligations under such instruments seem more like the secondary obligations under a guarantee contract under which the guarantor is not expected to pay on demand. It is, of course, possible for the parties to first demand security to incorporate some provisions of the URDG into their transaction and exclude others. Thus, it may not come into common use even if the URDG in general become widely accepted in international commercial practice.

\(^{156}\) [1985] 2 *Lloyd's Rep.* at p.546
demanding this from the beneficiary contradicts the whole concept of letters of guarantee.

When it receives a demand for payment the bank is required to take a number of actions before it would be able to pay the letter of guarantee. It is, for example, under the duty to inform the account party or the instructing bank, as the case may be, without delay of such demand and any documents received.\textsuperscript{157} It is also under the duty to examine the demand and the accompanying documents in order to check their conformity with the letter of guarantee terms and conditions and that the demand does not exceed the amount of the letter of guarantee.\textsuperscript{158} The bank is required to carry out its duty with regard to all these issues in a reasonable time. Neither the URCG nor URDG provides for the time according to which the bank has to fulfill its duty of examination. It is suggested that the bank's liberty in relation to the time needed for examination should be restricted. It seems therefore that there is a need for a similar provision of Art. 13(b) of the UCP to be contained in future rules of the letters of guarantee. This article limits the bank's time of examination to seven banking days. It provides:

"The issuing Bank, the Confirming Bank, if any, or a Nominated Bank acting on their behalf, shall each have a reasonable time, not to exceed seven banking days following the day of receipt of documents, to examine the documents and determine whether to take up or refuse the documents and to inform the party from which it received the documents accordingly."

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\textsuperscript{157} See Arts. 17 \& 21 URDG; see also Art. 8/2 URCG; Rowe M., "Contract guarantees: a supplier's dilemma". [1983] 28 Euromoney Trade Finance Report at p.29.

\textsuperscript{158} Art. 16 of the URDG.
In the case of standby letters of credit, the bank according to Section 5-108(b) of the UCC is required to fulfill its duty of examination within a reasonable time after presentation "but not beyond the end of the seventh business day of the issuer after the day of its receipt of documents." The same period of time is also provided by Art.16(2) of the Uncitral Convention.159

The demand for payment should be clear and unambiguous and be made in accordance with the terms of the letter of guarantee in that, for example, it is made in accordance with the stipulated currency. It should be presented to the bank on or before its date of expiry.160 If the bank decides that the demand conforms with the payment mechanism of the letter of guarantee it will pay unless a clear fraud is established. The bank should also refuse any demand that is presented by an unauthorised person. Accordingly, a demand for payment should be presented to the bank by the beneficiary or other designated person. The letter of guarantee should clarify the identity of the person who is entitled to make the demand for payment.161 The demand for payment and the required documents should also be presented to the bank at its place of issue.162 Alternatively the parties are at liberty to specify any

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159 Art.16(2) of the Uncitral Convention provides : "Unless otherwise stipulated in the undertaking or elsewhere agreed by the guarantor/issuer and the beneficiary, the guarantor shall have reasonable time, but not more than seven business days following the day of receipt of the demand and any accompanying documents, in which to:
(a) Examine the demand and any accompanying documents;
(b) Decide whether or not to pay;
(c) If the decision is not to pay, issue notice thereof to the beneficiary."

160 Art. 19 of the URDG; Art. 15 of Uncitral Convention.

161 Bertrams R., supra, at 71; Unlike the ordinary documentary credit, the stipulated documents, in the documentary letter of guarantee are not documents of title. In general, a certificate by the beneficiary that the principal has defaulted in its obligations to the beneficiary, or in some cases a court order or arbitral award to that effect; Perrignon R., "Performance Bonds And Standby Letters Of Credit" [1991] Journal of Banking and Finance Law and Practice 157 at p.158.

162 Art.15/2 of the Uncitral Convention.
other place for presentation in their agreement. It may be stipulated in the letter of guarantee that a demand for payment is to be made through a bank in the beneficiary's country. This is believed to assist the bank in confirming the beneficiary's signature, authority and identity before it proceeds with payment. In the case of a bank with multiple branches the demand for payment should be presented to the branch through which the letter of guarantee was issued at its counter during working hours. The demand for payment should be presented during the letter of guarantee's life time. The bank accordingly will refuse to accept any excuse by the beneficiary for the delay in presentation of the demand. The burden of proof that a proper presentation was made is on the beneficiary. The bank may however agree to reduce or to extend its working hours for the purposes of presentation.

When the beneficiary makes a demand for payment on the letter of guarantee he is deemed to be confirming that his demand has been made in good faith. The issue of the beneficiary's good faith in making a demand for payment was raised in the case of The Royal Bank of Scotland Ltd. v. Dinwoodie where a company was required to provide a third party with a performance letter of guarantee. As a requirement of issuing a performance letter of guarantee the bank asked the plaintiffs to undertake to pay any amount of money the bank might be forced to pay as a result of the

164 Art. 45 of the UCP.
165 Ibid.
167 see the Uncitral Convention articles 15(3), 19/1(a),(b) and (c).
168 (1987) S.L.T 82 at p.84
performance letter of guarantee. After the plaintiffs agreed to do so the bank issued the required letter of guarantee. Some time later the company went into liquidation and the bank was required to pay the performance letter of guarantee upon the beneficiary's demand. The bank, accordingly, sought payment from the plaintiffs. They alleged that the company had been wrongly debited by an amount paid by the bank and that the bank had been wrong to make payment. They accordingly contended that the bank had been wrong to seek to recover the payment from the company by debiting the company's bank account. The bank on its side contended that, as debtor in the performance letter of guarantee, it was not concerned with disputes between parties and that the amount paid under the performance letter of guarantee had been correctly paid. The bank sought a summary decree by supporting its position with some English precedents in this respect. The account parties, on their side, disagreed the bank’s viewpoint and contended that letters of guarantee terms and conditions in English authorities differ from the counter indemnity used in their case. The court held that a demand on the letter of guarantee could not be made so long as the contractors were still performing their obligations under the underlying contract. It also pointed out that it would only accept a demand on the letter of guarantee in the case of failure of performance by the contractors. In this case Lord Sutherland said:

"I accordingly turn to the terms of the guarantee and counter indemnity in the present case to see if they will bear the construction which the pursuers seek to put upon them. The first feature of the bond is that it contains no time or condition for payment and in particular contains no such phrase as 'payable on demand'. The second feature is that the obligations may be nullified by payment less of the than the

169 For more details see Ibid. at p.83.
total amount of the bond, this being brought about by the provision that 'if on default by the contractor, the surety shall satisfy and discharge the damages sustained by the employer thereby up to the amount of above written bond'.\footnote{170}

The court also believed that under the performance letter of guarantee the account parties were not liable for payment of the full amount. What they were in fact liable for the damages sustained by the beneficiary. The learned judge said that:

"Unlike the banks in the English cases who were bound to pay on default the whole sum contained in the bond whether or not any loss or damage was sustained, before being liable under this bond the [bank] would require to be satisfied at the very least that damages had been sustained by the employer, and as to the qualification of these damages".\footnote{171}

The court accordingly held that payment by the bank had been unnecessary and premature. It is argued that the court's decision goes against the legal nature of the letters of guarantee as being independent of the parties' relationship. When it paid the letter of guarantee, the bank was executing its part of the obligations as stated in the letter of guarantee. The bank was not concerned with the parties' disputes related to the underlying transaction. The only reason that could restrain a bank from payment, as it will be shown later in chapter four, is the case of clear fraud.\footnote{172}

The payment of the letter of guarantee may be conditional on the presentation of a beneficiary's notice of default stating that the account party is in breach of his underlying obligations.\footnote{173} This condition is acceptable to

\footnotesize{\begin{itemize}
\item \footnote{170}{Ibid.}
\item \footnote{171}{Ibid., at p.84.}
\item \footnote{172}{See infra Chapter 4.}
\end{itemize}}
the English courts. In the case of State Trading Corporation of India Ltd. v. E.D. & F. Man (Sugar) Ltd.,174 the court recognised the existence of such a condition by stating that:

"Should the seller fail for whatever reason to carry out its obligations under the contract the bank shall make payment immediately on the buyer's giving notice of the default notwithstanding any dispute between the buyer and the seller".

The instructions of the account parties on issuing the letter of guarantee or on payment should be clear. The bank is entitled to reimbursement despite any ambiguous instructions of the account party as long as these instructions are executed reasonably by the bank.175 In Rayner & Co. Ltd. v. Hambro's Bank Ltd, Goddard L.J said that:

"...if the bank wants to be reimbursed by the customer, it must show that it has performed its mandate. If I employ someone at a remuneration to pay money for me on getting a receipt in a particular form, and he pays the money without getting the receipt in that form, he has not carried out the duty which I imposed upon him. It would be no answer for him to say: 'But I got a receipt which in fact gives you all reasonable protection'. My answer to that would be: "You are not concerned which the protection which you have given me. You are concerned to carry out the orders which I have given you."177


177 Ibid at p.43.
3.5.2 Period Of Validity Of The Letter Of Guarantee.

The letter of guarantee expires if the bank does not receive any demand by the beneficiary during the letter's of guarantee period. Every letter of guarantee should specify a final date by which the demand for payment must be received by the bank. If the letter of guarantee ceases to be valid, the bank should not pay, unless it is authorised by the account party or instructing bank as the case may be.

In practice the expiry date of the letter of guarantee could take one of the following forms:

(a) an expiry date that might refer to a specified calendar date or the last day of a fixed period of time specified in the letter of guarantee, for example, specifying the 2nd of June 1997 as the date of expiry. But if it appeared that the expiry date is not a business day at the place of business of the bank at which the letter of guarantee is issued, or of another person or at another place stipulated in the letter of guarantee for presentation of the demand for payment, the letter of guarantee expires on the first business day which follows. The letter of guarantee should specify the first date from which the

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178 Art. 42(b) of the UCP: As regard to standby letters of credits see the regulations of comptroller of the currency. 12 CFR article 7.7016 which provides" A national bank may issue letters of credit permissible under the uniform commercial code or the uniform customs and practice for documentary credits to or on behalf of its customers. As a matter of sound banking practice, letters of credit should be issued in conformity with the following:
(a) each letter of credit should conspicuously state that it is a letter of credit or be conspicuously entitled as such;
(b) the bank's undertaking should contain a specified expiration date or be for a definite term;
(c) the bank's undertaking should limited in undertaking;"

179 See Art.3 of the URCG which takes the approach that letters of guarantee without a date of expiry are considered as valid for an unlimited period of time.

180 See Art.12 of the Uncitral Convention and Arts. 4&5 of the URCG.

181 e.g., Dowling v Henderson (1890) 17 R 921.

182 See Art.12(a) of the Uncitral Convention.
time is to run, and state, for example, that "this letter of guarantee is valid for six months from the 1st of April 1996". Failing to specify such date, the date of issuance of the letter of guarantee by the bank will be considered to be the first day from which such time is to run.183

(b) upon the occurrence of an "expiry event", where the bank's obligation to pay terminates upon the presentation of specified document(s) such as a document by an engineer testifying the completion of the project by the account party.184

(c) by a combination between the "date and the event of expiry" where the letter of guarantee states that it expires on the 1st of April 1997 or following a presentation of a document by the beneficiary releasing the account party from liability, whichever occurs first.185

The letter of guarantee may expire upon the presentation to the bank of either the letter of guarantee document or the beneficiary's written statement that releases the account party from the liability. The fact that the letter of guarantee document was returned to the bank should not affect the question of the validity of the letter of guarantee.186

(d) when the purpose for which the letter of guarantee was issued is completed.

In case of a performance letter of guarantee the bank is absolved from its obligation to pay upon the receipt of a certificate from the beneficiary or a third party such as an engineer or a surveyor, certifying that completion of the

183 See Art. 42/c of the UCP.
184 e.g., Siporex v Banque Indosuez [1983] 2 Lloyd's Rep. 146 at p.164.
185 Art.22 of the URDG; Art. 12(b) of the Uncitral Convention.
186 Art.23 of the URDG.
underlying transaction or the purpose according to which the letter of guarantee has been issued.187

When it issues a letter of guarantee the bank is always advised to set out clearly the date or event on which the letter of guarantee expires. Letters of guarantee that include no specific expiry date are problematic. They put the bank under a continuous obligation to pay. Art. 4 of the URCG sets forth a number of solutions to the problem of the absence of a specified expiry date of the letter of guarantee. These solutions depend on the type of letter of guarantee involved. In the case of a tender letter of guarantee, for example, it is deemed to expire after six months from the date of issuance. Art. 5 of the same rules adds more reasons for the expiry of the tender letters of guarantee.

According to the article a tender letter of guarantee may also expire when one or more of the following events occur:

"(a) upon acceptance by the beneficiary of the tender by the award of the contract to the (account party) and, if so provided for in the written contract, or, if no contract has been signed and it is so provided for in the tender, the production by the (account party) of a performance guarantee or, if no such guarantee is required the signature by the (account party) of the contract, the tender guarantee issued on his behalf ceases to be valid;

(b) a tender guarantee also ceases to be valid if and when the contract to which it relates is awarded to another tenderer, whether or not that tenderer meets the requirements referred to in para. 2 (a) of this Article;188"

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187 e.g., Price & Co v. Tennent (1844) 6 D 659; Black v Cullen (1835) 15 D 646.

188 Art.2(a) of the URCG provides: "tender guarantee" means an undertaking given by a bank, insurance company or other party ("the guarantor") at the request of a tenderer ("the principal") or given on the instructions of a bank, insurance company, or other party so requested by the principal ("the instructing party") to a party inviting tenders ("the beneficiary") whereby the guarantor undertakes-in the event of default by the principal in the obligations resulting from the submission of the tender-to make payment to the beneficiary within the limits of a stated sum of money."
(c) A tender guarantee also ceases to be valid in the event of the beneficiary expressly declaring that he does not intend to place a contract."

A solution to the problem of the absence of an expiry date in the performance bond may also be found in Art. 4 of the URCG. If the performance letter of guarantee states no expiry date, the article provides that the expiry date of the letter of guarantee takes effect six months from the date stipulated in the contract of delivery or completion or any extension thereof. For example, if a performance letter of guarantee is issued to guarantee the delivery of factory industrial machines on the 2nd of June 1995, such letter of guarantee will be deemed to have expired on the 2nd of November of the same year even if no expiry date was specified in the letter of guarantee itself. Sometimes the performance letter of guarantee may explicitly cover a maintenance period for the industrial machines which were delivered under the performance letter of guarantee. According to the same rules the performance letter of guarantee will be deemed to have expired after one month of the maintenance period.

In the case of the absence of expiry date of repayment letters of guarantee, the URCG deems the repayment letter of guarantee to be expired six months from the date specified in the contract for delivery or completion or any extension thereof. For example, the repayment letter of guarantee will be deemed expired if the account party fails to make a demand for payment six months after the date of the completion of the project as stated in the letter of guarantee.

It seems that the URDG provides for no solutions to the problem of the absence expiry date in the case of on-demand letters of guarantee. The Uncitral Convention on the other hand sets forth a solution to the problem of

189 Art. 4 of the URCG.
the absence of an expiry date in the case of independent letters of guarantee and the standby letters of credit.\textsuperscript{190} Art. 12(c) of the Convention provides that the validity period of the undertaking expires:

"If the undertaking does not state an expiry date, or if the act or event on which expiry is stated to depend has not yet been established by presentation of the required document and an expiry date has not been stated in addition, when six years have elapsed from the undertaking"

The letter of guarantee may also deemed to be expired if:

"no claim has been received by the (bank) on or before the expiry date or if any claim arising under the guarantee has been settled in full satisfaction of all the rights of beneficiary thereunder." \textsuperscript{191}

Should the letter of guarantee terminate as a result of expiry, the bank is required, without delay, to notify the account party or the instructing bank, in the case of an indirect letter of guarantee.\textsuperscript{192} The bank's obligation to pay seems to be indefinite in terms of duration under certain legal systems. The date of expiry is not recognised by the national laws of some countries. It is an acceptable practice in some countries therefore to make payment after the expiry date of the letter of guarantee. According to such legal systems the letter of guarantee continues to be valid until the beneficiary has rendered the letter of guarantee instrument or issued a declaration of release.\textsuperscript{193} The


\textsuperscript{191} Art. 5 of the URCG.

\textsuperscript{192} Art. 25 of the URDG.

\textsuperscript{193} Under Syrian law, for example, the letter of guarantee will remain valid until it is physically surrendered and under Turkish law a letter of guarantee has an automatic life of ten years irrespective of any expiry date within the bond itself. Rowe M., "Contract guarantees: a supplier's dilemma". [1983] Euromoney Trade Finance Report at p.28.
instructing bank, accordingly, may find itself in the dilemma because the counter letter of guarantee it has obtained from the account party may cease to be valid while the letter of guarantee is still valid from the national law point of view. In the light of this problem the issuing banks are therefore advised to obtain a counter letter of guarantee that covers all the possible future claims under the counter letter of guarantee. 194

The bank should extend the letter of guarantee to the first subsequent business day if the expiry date of the letter of guarantee coincides with a non-business day.195 A "non-business" day in this respect should be taken as the "non-business" day of the place or the country of the bank and not the place or country of the beneficiary. When it makes such an extension the bank is under the duty to provide the account party or the instructing bank, as the case may be, with a statement that the demand and/or the supporting documents were presented within the time limits and to justify the extension.196

In addition to the expiry date, the cancellation of the letter of guarantee is another reason for the termination of the bank's obligation to pay. Cancellation might take place on to the presentation of either the beneficiary's written statement releasing the account party from liability or of the letter of guarantee itself.197 In practice, there seems to be no need for the letter of guarantee to be returned to the bank for cancellation if the bank receives a beneficiary's written statement of release.198 However, the bank might

194 Penn G., "On-demand Bonds Primary or Secondary Obligations", supra, at p.228.
195 Art. 44 of the UCP.
196 See Art. 44(c) of the UCP.
197 Goode, R., Guide To The ICC Uniform Rules for Demand Guarantees, supra, at p.106; See also Art.23 of the URDG.
sometimes insist on the returning of the tender letter of guarantee document, for example, for the purpose of cancellation before it issues a performance letter of guarantee. In practice, banks ask beneficiaries to return the letter of guarantee document to the bank without delay when it ceases to be valid.200

Some banks explicitly stipulate in the letter of guarantee that it is deemed to be terminated upon the returning of the letter of guarantee document to the bank.201 When they issue letters of guarantee to beneficiaries in other countries the English banks should notice that according to the jurisdiction of these countries the letters of guarantee may continue to be valid despite the date of expiry as long as the letter of guarantee has not been returned by the beneficiary. It appears that the URDG minimise the importance of the retention of the letter of guarantee document. According to Art.18 of the rules the letter of guarantee is considered to be terminated even without the need for the returning of the letter of guarantee document. Arts. 22, 23 and 24 of the same rules also says that the validity or invalidity of the letter of guarantee is not affected by whether the letter of guarantee document was returned to the bank or not.202 The retention of the letter of guarantee

198 See Art.23 of the URDG.
200 See Art.6 of the URCG.
201 See Art. 11(2) of the Uncitral Convention.
202 Art.22 of the URDG provides: "Expiry of the time specified in a Guarantee for the presentation of demands shall be upon a specified calendar date ("Expiry Date") or upon presentation to the Guarantor of the document(s) specified for the purpose of expiry ("Expiry Event"). If both an Expiry Date and an Expiry Event are specified in a Guarantee, the Guarantee shall expire on whichever of the Expiry Expiry Date or Expiry Event occurs first, whether or not the Guarantee and any amendment(s) thereto are returned." Art.23 also provides: "Irrespective of any expiry provision contained therein, a Guarantee shall be cancelled on presentation to the Guarantor of the Guarantee itself or the Beneficiary’s written statement of release from liability under the Guarantee, whether or not, in the latter case, the Guarantee or any amendments thereto are returned." And finally Art.24 of the same rules provides:"Where a Guarantee has terminated by payment, expiry, cancellation or
document should not grant the beneficiary any rights under the letter of guarantee. In the light of the aforementioned problems, it is suggested that the such problems can be avoided if the exporter can persuade the beneficiary to issue a letter of guarantee through an English bank or at least insist that the letter of guarantee be subject to English law.

The beneficiary may sometimes endeavour to put some pressure on the account party to carry out more duties than those agreed upon in the underlying contract, or to keep the letter of guarantee valid as long as possible by resorting to what is commonly known as the "extend or pay" practice.203 Such an attitude tends to be more common in the case of tender letters of guarantee where the beneficiary asks the bank either to extend the validity period of the letter of guarantee or to have it paid. It may be argued that this practice should be accepted as a way of enabling the beneficiaries to enhance their chance of performing the underlying contract properly by putting some pressure on the account parties. Such view was dismissed by the court in the case of United Trading Corporation S.A. v. Marry Clayton Ltd.204 In this case the court believed that the "extend or pay" way of practice could be more commonly used improperly to obtain an illegitimate benefits from account parties.205 In this case Kerr L.J. said that:

"The plaintiff took a commercial risk that the performance bonds might well be called in dishonestly by the beneficiary. When the plaintiffs gave the banks instructions to extend the time limits of the performance bonds, the plaintiffs, as was otherwise. retention of the Guarantee or any amendments thereto shall not preserve any rights of the Beneficiary under the Guarantee."

203 Penn G., "On-demand Bonds Primary or Secondary Obligations?", supra, at p.228.
conceded, intended to claim that any call on the performance bonds during such extended period or periods would be fraudulent. Needless to say, the plaintiffs did not disclose their intentions to the bank. 206

This practice was also discouraged by URCG rules. Art. 7(1) of the rules provides:

"A tender guarantee is valid only in respect of the original tender submitted by the (account party) and does not apply in the case of any amendments thereto, nor is it valid beyond the expiry date specified in the guarantee or provided for by these Rules, unless the guarantor has given notice in writing or by cable or telegram or telex to the beneficiary that the guarantee so applies or that the expiry date has been extended."

The article clearly discourages the account parties from extending the validity of their tenders or of re-negotiating their terms under the pressure and the threat of the beneficiary to claim payment on the tender letter of guarantee. Art. 26 of the URDG on the other hand says that banks should not be affected by the threats of the beneficiaries over paying or extending the letter of guarantee. The article also points out that the bank is under the duty to obtain the account parties’ consent before being in a position to extend the life time of the letter of guarantee. It provides:

"If the Beneficiary requests an extension of the validity of the Guarantee as an alternative to a demand for payment submitted in accordance with the terms and conditions of the Guarantee and these Rules, the Guarantor shall without delay so inform the party who gave the Guarantor his instructions. The Guarantor shall then suspend payment of the demand for such time as is reasonable to permit the Principal and the Beneficiary to reach agreement on the granting of such extension and for the Principal to arrange for such extension to be issued."

The bank accordingly is required to transmit the beneficiary's request without delay to the account party. The account party on his side should reach a decision in a reasonable time as to whether or not to give his consent to extending the letter of guarantee. This procedure should not take the life of the letter of guarantee. The "extend or pay" request subsequently raises the question of how the bank should react if it does not obtain an answer from the account party as to whether to extend or to pay the letter of guarantee within a reasonable time and what would be the method in determining the reasonable time? In the light of the absence of a definition of reasonable time with accordance to Art. 26 of the URDG it is suggested that the bank is required to use its discretionary powers in order to decide whether or not the account party has replied in a reasonable time. If it is decided that the account party has not answered in a reasonable time, the bank has the choice either to pay or to extend the letter of guarantee. But how could the bank extend the letter of guarantee without the account party's consent? The answer is that the bank is totally free to extend the letter of guarantee if it does not receive an answer from the beneficiary within a reasonable time based on the account party's implied authority to extend the duration of the letter of guarantee in order to avoid payment which could be considered as a solution in favour of the account party.207 The other question which might be also raised as a result of the "extend or pay" practice is how the bank would react if an answer from the account party did not reach the bank until the letter of guarantee had expired. It seems that in this case the bank remains under an obligation to pay even if the letter of guarantee turns out to be invalid as a result of the parties'
negotiations. If it paid after the expiry of the letter of guarantee the bank should not be held liable for any delay in payment as a result of the above mentioned procedures. Thus, the bank should always bear in mind that a wrongful response to an "extend or pay" demand might place it in a very difficult position and therefore is required to act very carefully since its right to be reimbursed by the account party very much depends on its correct decision. In the light of these expected difficulties it is suggested that the bank should insert a clause which gives it the authority to respond, without the need of the account party's consent to any demand for extension whenever it finds necessary to do so.

3.5.3 The Bank's Duty Of Verification.

The payment of the letter of guarantee depends on the fulfillment of the terms and conditions as stated by the letter of guarantee document. In practice this is known as the payment mechanism. It could be summarised as being the process of tendering a complying written demand and documents that usually certify the account party's default. Just as in the case of documentary letters of credit, the bank under a documentary letter of guarantee is required to verify the documents presented to it by the beneficiary. It should examine all the presented documents with reasonable care before it proceeds to payment. The bank should refuse to pay if it finds out that the documents do not appear on their face to conform with the terms of the letter of guarantee208 or if they appear not to be consistent with each other.209 Failing to perform its duties of examination properly would render the bank liable to the account party if it

208 See Art. 11 of the URDG.
209 See Art. 9 of the URDG.
proceeded to payment. The duty of the bank's verification might raise the question of the extent to which the bank is required to perform this duty and what the effects of such a duty would be on its neutral position under the letter of guarantee. In order to keep itself clear of involvement in disputes between the parties to the underlying relationship, the bank should make clear in the letter of guarantee document that its obligation to pay is determined on the basis of the documents presented under the letter of guarantee; i.e. by merely matching the documents presented by the beneficiary with those prescribed in the letter of guarantee. The bank is not required to go beyond the presented documents in order to examine the beneficiary's right to payment on the basis of the underlying contract. It accordingly does not have to decide on the genuineness of the beneficiary's allegations. It is simply entitled to pay if the demand and the accompanying documents appear on their face to match the letter of guarantee requirements. This principle was emphasised by the court in the case of Siporex v. Banque Indosuez. In this case Hirst J. said:

"The problem here is that the bank, on receipt of the documents, are obliged to compare them with terms of the contract. They would at once observe these discrepancies, and it would be quite impossible for them to resolve them one way or another simply by examination of the documents


211 Unlike the ordinary documentary letters of credit, the stipulated documents in the letters of guarantee are not documents of title. Such documents are in most cases a certificate by the beneficiary that the principal has defaulted in his obligations to the beneficiary, or a court order or an arbitral award to that effect; Perrignon R., supra, at p.158.


with which alone they deal. They would have to investigate, and ask questions, which is not their proper function."

In order to decide whether or not to pay, the bank according to the URDG should examine the demand for payment within a reasonable time. If it decides not to pay, it should immediately notify the beneficiary by teletransmission or, if that is not possible, by other expeditious means.

Allowing the bank to perform its duty of examination within a reasonable time may raise the question of how long it has to decide whether or not to pay the letter of guarantee. The term "reasonable time" is believed to be vague and obscure and could lead to protracted procedures without any restrictions or limitations on the banks' side. It seems that both Art. 13 of the UCP and Art. 16(2) of the Uncitral Convention set forth a better definition in this respect. Both articles limit the time of examination as not exceeding seven banking days following the day of the receipt of documents.

It may be also added that the absence of a clear definition of what is meant by a "banking day" could create some difficulties in respect of the bank's duty of examination. This issue becomes more serious in some financial centres where banks are open for business for half day on Saturdays. Such differences between the banks all over the world show the need for a change.

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214 See Art. 10(a) of the URDG.
215 See Art. 10(b) of the URDG.
in the bank's period for verification, if it is going to be restricted, to be referred to a calendar day rather than a working day.\textsuperscript{219}

The bank's duty of examination in a reasonable time would also raise the question of whether it is permitted to consult its customer or to send him documents for the purpose of examination and identification prior to payment. This point was dealt with by the Court of Appeal in the case of Banker's Trust Co. v. State Bank of India.\textsuperscript{220} In this case Farquharson L.J. stated:

"If it is the custom among bankers, as the evidence disclosed, to inquire of the applicant for a letter of credit whether it wished the bank to reject the documents in reliance on the discrepancies it has found, it should be permitted to do so within the ambit of the reasonable time required to make its determination.....if the task of the issuing bank is restricted to the examination of the documents, there is no room for it to make any determination. If it discovers any discrepancies its function is simply to reject the documents. The making of a determination in my judgment implies something more".\textsuperscript{221}

This case indicates that the banks should adhere to the time limit in verification of documents and that their consultation with their customer could prolong the verification process.

After completing the verification of documents, the bank should hold all the documents at the disposal of the beneficiary.\textsuperscript{222} The beneficiary should

\textsuperscript{219} Ibid.


\textsuperscript{221} Ibid. at pp.454-5.

\textsuperscript{222} Art.10(b) of URDG: e.g., Banker's Trust Co. v. State Bank of India [1992] 2 Lloyd's Rep. at p.443. Lloyd L.J. stated that "... as soon as the documents have been rejected, they should be put back in circulation". Petkovic D., "UCP 500: Evolution not Revolution", supra, 39 at p.41.
be notified of the bank's decision if it has decided not to pay following the examination of the documents. In the case of the standby letters of credit, the bank is required either to return the documents to the beneficiary or to notify him that it holds the documents at his disposal. Failing to comply with this requirement may result in the bank being liable for the full amount of the standby letter of credit.

223 See Art. 16/2(c) of the UNCITRAL Convention.

CHAPTER FOUR

THE EFFECT OF FRAUD AND INTERLOCUTORY INJUNCTIONS ON A BANKS' OBLIGATION TO PAY.

4.1 General.

The bank's obligation to pay under a letter of guarantee is independent of the underlying transaction. It is, therefore, obliged to pay the beneficiary or his assignees whenever it receives a proper demand notwithstanding any opposition by the account party. However, the bank should not pay if the demand is tainted with fraud or unfair calling. Fraud under a letter of guarantee transaction constitutes an exception to the bank's obligation to pay upon the beneficiary's demand. Banks are always placed in a critical position when fraud is claimed by the account party. They try to maintain the balance between their relationship with the customers, and that of honouring their obligation to pay under the letters of guarantee. They will be liable to the account party, if they pay in spite of the fraud, unless it can be shown that they have acted reasonably. On the other hand, if payment is refused without proper justification, they will be subjected to a claim of wrongful dishonour.

The URDG does not provide a solution to the issue of beneficiary fraud. It leaves unanswered the question whether a bank which has knowledge of the fraud, or the presence of false in the submitted documents, should reject the demand and refuse payment, though the documents look conforming. No express provision authorises the bank not to pay against conforming documents, even when there is an underlying fraud. However, the URDG does not exclude the possibility of non-payment. Art. 11 of the URDG reads as follows:- "Guarantors and Instructing Parties assume no liability or
responsibility for the form, sufficiency, accuracy, genuiness, falsification, or legal effect of any document presented to them for the general and/or particular statements made therein, nor, for the good faith or acts or omissions of any person whomsoever."

The fraud exception under the letter of guarantee raises some difficult legal issues. What is the effect of an allegation of fraud, unfair calling and manifest abuse upon the bank's obligation to pay under the letters of guarantee? What is the position when the beneficiary is not party to the alleged fraud exception? May the account party obtain a court injunction restraining payment and if so on what conditions?

4.2 The Notion Of Fraud (Exceptio doli mali)

In general, English courts always believed that letters of guarantee should be protected. The courts however have accepted fraud to be the only exception to the principle of the independence of the underlying contract from the letter of guarantee.225 The problem in dealing with these issues, therefore, was whether the courts have the right to look into the contract between the account party and the beneficiary, a practice which is prevented by the principle of the independence of contracts from letters of guarantee. The courts have taken the view that there is a right to interfere with the underlying contract if fraud is proved, a view which has brought a lot of controversy in this area of law, as it conflicts with the basic letters of guarantee principle that the contract between the account party and the beneficiary is separate from and independent of that between the bank and the beneficiary. This

225 e.g., Hamzeh Malas and Sons v. British Imex Industries Ltd, [1985] 2 Q.B. 127 at p.129; In United City Merchants v. Royal Bank of Canada, [1983] 1 A.C 168, the court realised the importance of the courts' interference in the case of fraud by debarring the beneficiary from benefiting from his fraudulent behavior. Lord Diplock stated: "The basis for the exception is that the courts will not allow their process to used by a dishonest person to carry out fraud".
controversy had resulted, as will be shown latter, in two different approaches of the English courts. According to the first approach, the courts were tempted to interfere in the underlying relationship of the parties in order to examine the fulfillment of the account party's obligations under the letter of guarantee. Interference by the court becomes essential if the fulfillment of the obligations is stipulated in the underlying contract as a condition of payment. Other courts, however, preferred to avoid interference in the parties contractual relationship.

Fraud in letters of guarantee transactions has been recognised by the English courts on several occasions to be the sole defence against payment. In the United City Merchants (Investments) v. Royal Bank of Canada [American Accord],226 the rationale behind the fraud exception was stated by Lord Diplock in the following words:

"The exception for fraud on the part of the beneficiary seeking to avail himself of the credit is a clear application of the maxim ex turpi causa non oritur actio or, if plain is to be preferred, "fraud unravels all." The courts will not allow their process to be used by a dishonest person to carry out a fraud."227

In the landmark case of Edward Owen Ltd v. Barclays Bank International Ltd,228 Lord Denning M.R pointed out that: "the bank ought not to pay under the letter of guarantee or credit if it knows that the documents are forged or that the request for payment is made fraudulently in circumstances when there is no right to payment".229 The words of Lord Denning suggest that fraud

226 [1983] 1 A.C 168
228 [1978] All ER 976.
229 [1978] All ER 976. The same approach was also adopted in Centri-Force Engineering Ltd v. Bank of Scotland. [1995] 5 SLT 190, when Lord Abernethy made it clear that fraud exception applies in the same way in Scots law.
could be described as the condition whereby the beneficiary's demand for payment has no conceivable basis in the underlying transaction. A fraudulent demand, therefore, could take the form of something untrue invented by the beneficiary under the letter of guarantee. The beneficiary's demand for payment is fraudulent, for example, if his allegations of the account party's default under the letter of guarantee were proved to the contrary by a certificate issued by the beneficiary testifying the completion of the account party's obligations under the letter of guarantee. Fraud may also be committed, for example, when forged or fraudulent documents are presented to the issuing bank for payment under the letter of guarantee. In practice two different types of fraud may be involved under the letter of guarantee. In the first place, the beneficiary may have forged the documents or some of them e.g. forged the signature of the surveyor's report under the letter of guarantee. In the second situation, the document itself may contain a false statement or statements, e.g. the engineer's report may contain false information confirming the account party's default in performing his secured obligations.

Fraud in the letter of guarantee transaction could also take the form of unfair calling or manifest abuse of the beneficiary's rights under the letter of guarantee. Unfair calling or manifest abuse of the letter of guarantee is believed to take place when a demand is made in accordance with a nonexistent or unfair reason in circumstances where "a beneficiary may seek, honestly or dishonestly, to apply a performance bond to the wrong

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230 Pierce A., supra., at p.233.

231 Becker J., "Standby Letters of Credit and Iranian Cases; will the Independent of Credits Survive?" [1981] 13 Uniform Commercial Code Law Journal 335 at p. 337 who states that: "...although often the first demand guarantee will have been called and paid in a procedurally correct manner, the underlying reason for the call may be unfair or non-existent. The validity of the call may hence be challenged by the account party."
contract”. Such a situation may exist, for example, if the beneficiary makes a demand on a letter of guarantee on the basis of a different underlying transaction between him and the account party that is not secured by the letter of guarantee. Or if the beneficiary tries to put some pressure on the account party to force him to bear extra expenses as a result of the underlying contract modification under the threat of calling the letter of guarantee.

Another example of the beneficiary's manifest abuse of his rights under the letter of guarantee is the "extend or pay" request. The beneficiary, however, is not considered to abuse his rights if the purpose of the "extend or pay" request was to open a door for negotiations between the parties and to give the account party the chance to perform his obligations properly under the letter of guarantee. The beneficiary may also be considered to abuse his right to demand the letter of guarantee if he makes a demand after a very short time of issuance of an on-demand letter of guarantee without giving the account party the chance to perform his obligation in accordance with the underlying transaction.

A fraudulent or abusive call by the beneficiary may also take place in the case of tender letters of guarantee if the beneficiary started to threaten the account party to call the guarantee so as get an extension or to put him under pressure to accept some extra expenditures which were not originally mentioned in the tender invitation.

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232 e.g., Esal (Commodities) Ltd and Retlor Ltd v. Oriental Credit Ltd and Wells Fargo Bank N.A. [1985] 2 Lloyd's Rep. 546.
233 Horn N. Wyneersh E., Bank-Guarantees, Standby Letters of Credit and Performance Bonds in International Trade, (1989) at p.34.
235 Pierce A., supra, at p.198.
All these sorts of conduct by the beneficiary may be considered as possible forms of fraud under the letters of guarantee. As a general rule the account party is not able to stop the bank from honouring its obligation to pay unless he can prove the beneficiary's fraudulent demand. He is normally required to adduce sufficient evidence of fraud to justify the court's decision to restrain the bank from payment.

4.3 The Evidence Of Fraud

Fraud must be clearly established in court in order to be accepted as a defence against payment under the letter of guarantee.236 English courts, however, are not unanimous on the degree of fraud that should deny the beneficiary payment under the letter of guarantee. It seems that the courts' concept of fraud depends on the degree they are ready to accept fraud as a defence against payment. They accordingly have shown two different approaches towards fraud. Firstly, a restrictive approach has been shown by the courts in many cases, where fraud as a defence against the bank's obligation to pay has only succeeded in relatively few cases.237 This result may be explained by the reluctance of the English courts to interfere in the parties' contractual relationship under the letter of guarantee.238 In Potton Homes Ltd v. Coleman Contractors (Overseas) Ltd.,239 for example, the


237 Jack R., Documentary Credits, supra, at 213 where he cited Tukan Timber [1987] 1 Lloyds Rep. 171. and Rabbath v. Matsas and Matsas [1966] 2 Lloyds Rep. 495. In the latter case the ship owners claimed a lien based on demurrage over certain goods, by furnishing the ship owners with an on-demand guarantee demurrage over certain goods, accordingly the owners tried to release the lien, after lifting the first lien upon receiving the guarantee, the ship owners claimed another lien, the Court of Appeal granted an injunction restraining the ship owners from drawing under the letter of guarantee.


court refused to restrain the bank from payment due to an alleged fraudulent reason that arose from the underlying contract. In this case Eveleigh L.J believed that if the courts started to grant injunctions against payment generously:

"... it will be possible on future occasions to undermine the absolute undertaking of the bank given in 'on-demand' bonds, by simply claiming a defence arising from the underlying contract. Such a situation could not be the parties' intention when negotiating 'on-demand' bonds."240

Accordingly, the courts strongly believe that the bank's obligation to pay under the letter of guarantee is an absolute and should not be interfered with by them.241 They also believe that letters of guarantee should be always treated as being cash in hand.242 In Intraco Ltd v. Notis Shipping Corporation,243 it was stated by Donaldson L.J:

"Irrevocable letters of credit and bank guarantees given in circumstances such that they are the equivalent of an irrevocable letter of credit have been said to be the life blood of commerce. Thrombosis will occur if, unless fraud is involved, the Courts intervene and thereby disturb the mercantile practice of treating rights thereunder as being equivalent of the cash in hand."244

The courts' reluctant tendency to interfere in letters of guarantee transactions has been also expressed by the court in R.D Harbottle

240 Ibid., at p.28.
242 Bertrams R., Bank Guarantee in International Trade, at p.344.
244 Ibid., at 257.
(Mercantile) Ltd v. National Westminster Bank Ltd.\textsuperscript{245} where an injunction was sought to restrain the issuing bank from honouring a first demand letter of guarantee on the basis that the beneficiaries demand was tainted with fraud.

The court in that case ruled that the role of the courts in letters of guarantee relationship should be restricted to very exceptional cases. In this case Kerr L.J held that:

"It is only in exceptional cases that the courts will interfere with the machinery of irrevocable obligations assumed by the banks. They are the life blood of international commerce. Such obligations are not regarded as collateral to the underlying rights and obligations between the merchants at either of the banking chain. Except possibly in clear cases of fraud of which the banks have notice, the courts will leave the merchants to settle their disputes under the contracts by litigation or arbitration as available to them or stipulated in the contracts."\textsuperscript{246}

Again, in Howe Richardson Scale Co Ltd v. Polimex-Cekop\textsuperscript{247} the court refused to restrain the bank from payment on the ground that interference in the parties' relationship will undermine the principle of independence by putting the bank under the pressure to interfere in the underlying relationship. In this case Roskill L.J said:

\textsuperscript{245} [1978] 1 Q.B. 146 at 155; See also, for example, Intraco v. Notise Shipping Corp. (Bohja Trader), [1981] 2 Lloyd's L.R. 256; Howe Richardson Scale Co. Ltd v. Polimex-Cekop and National westminster Bank Ltd., [1978] 1 Lloyd's Rep. 161, at p.165, in this case Roskill L.J., said that "Whether the obligation arises under a letter of credit or under a guarantee, the obligation of the bank is to perform that which it is required to perform by the particular contract and that the obligation does not in the ordinary way depend on the correct resolution of a dispute as the sufficiency of performance by the seller as the case may be under the sale and purchase contract, the bank here is simply concerned to see whether the event has happened upon which its obligation to pay has arisen".

\textsuperscript{246} Ibid. at p.155.

"[In my view it would be quite wrong for the court to interfere with Polimex's (beneficiary) apparent right under this guarantee to seek payment from the bank, because to do so would involve putting on the bank an obligation to inquire whether or not there had been timeous performance of the sellers' obligation under the sale contract."248

Similarly in Edward Owen Engineering Ltd. v. Barclays Bank International Ltd.249 an allegation of fraud was dismissed by the court on the basis that the evidence adduced by the account party must show an established fraud. Browne L.J., was reported to have said:

"That exception is that where the documents under the credit are presented by the beneficiary himself and the bank knows when the documents are presented that they are forged or fraudulent, the bank is entitled to refuse payment. But it is certainly not enough to allege fraud, it must be established, and in such circumstances I should say very clearly established."250

The judge's approach in this case reflects the high standard of evidence of alleged fraud which is normally required by the courts to absolve the bank from its duty to pay. The courts have always emphasised that the required evidence of fraud should be "as clear as the sun", or it must appear "beyond a reasonable doubt",251 "to hit the eyes",252 "crystal clear" or to be "blatant" before a restraining order could be granted against the bank.253

248 Ibid. at p.165.
250 Ibid. at p.984.
251 Horn N., Wymeersh E., Bank-Guarantees, Standby Letters of Credit and Performance Bonds in International Trade, supra, at p.47.
252 Pierce A., Demand Guarantees in International Trade, supra, at p.197.
Fraud must be proved and not based on mere allegations, suspicion or possibility. In *United Trading Corp. v. Allied Arab Bank Ltd.* the Court of Appeal set forth the nature of the evidence of fraud required. It pointed out that neither fraud allegations, or suspicions by the account party, nor by the bank, are considered sufficient cause to restrain banks from payment. It accordingly accepted fraud as a defence against payment under very exceptional circumstances. In this case Ackner L.J said:

"we would expect the court to require strong corroborative evidence of the allegation, usually in the form of contemporary documents, particularly those emanating from the [beneficiary]."

Such a restrictive approach towards fraud by the English courts makes it sometimes very difficult to establish. It may also undermine the notion of fraud of being sufficient means to challenge unjustified demands under the letters of guarantee. This conclusion may be supported by the words of

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256 e.g., *British Inex Industries v. Middle Bank*, [1958] 1 Q.B. 542.
258 See Penn G., Shea A., and Arora A., *The Law and Practice of International Banking* (1987) at p.288; See also *United Trading Corporation v. Allied Arab Bank*, supra, Per Ackner L.J. he said that ;"we would find it an unsatisfactory position if, having established an important exception to what had previously been thought an absolute rule , the courts in practice were to adopt so restrictive an approach to the evidence required as to prevent themselves from intervening".
259 Guest A.G. supra. at pp.1573-74.
Ackner L.J. in the *United Trading Corp. v. Allied Arab Bank Ltd* where he said:

"[A] requirement of excessive strictness with respect to the proof of fraud would make it impossible for the courts to apply this exception at all to the principle of autonomy of the credit."

In the manner and standard of proof, therefore, the courts seem to require some additional element which has proved to be very elusive, even where the facts are clearly in favour of the account party. But, needless to say, this judicial attitude cannot be condemned. It is in total agreement with the commercially accepted principle of the autonomy of the letter of guarantee.

This is coupled by the banks' awareness that they risk erosion of confidence in them by the business community if they allow themselves to restrained from honouring their obligations.

The English courts' restrictive approach was interpreted by Professor Goode as meaning that "the banker's action must depend upon the strength of its knowledge. It can take no account of mere suspicion except, perhaps to delay payment until the suspicion is confirmed or dispelled, even so, it can not delay for long and if it can not ascertain what the position is within a short time, and the documents are on their face in order, it must pay."  

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260 Supra at 554; see also Schmitthoff C., *The Law and Practice of International Trade*, supra, at p.377.

261 Ibid. at p.561.


Secondly, a more flexible approach towards the notion of fraud can be found in other English court decisions. In Tukan Timber v. Barclays Bank, Hirst J. argued for a much more liberal approach to the standard of proof required for the purpose of obtaining relief in allegations of fraud. He argued that it would be "a satisfactory position if having established an important exception to what had previously been thought an absolute rule, the courts in practice were to adopt so restrictive approach to the evidence required as to prevent themselves from intervening. Were this to be the case, impressive and high-sounding phrases such as 'fraud unravels all' would become meaningless".

A wider concept of fraud may also be noticed in the words of Lord Denning M.R. in the State Trading Corporation of India Ltd. v. E.D and F. Man (Sugar) and the State Bank of India. He said:

"[T]he [beneficiary], when giving notice of default, must honestly believe there has been a default on the part of the [account party]. Honest belief is enough. If there is no honest belief, it may be evidence of fraud. If there is sufficient evidence of fraud, the court might intervene and grant an injunction. But otherwise not. So long as the [beneficiary] honestly believes there is default on the part of the [account party], that is sufficient ground for a notice of default to be given."

The court's decision suggests that the bank is under an obligation to refuse payment where there is no honest belief in the beneficiary’s demand or where

265 Ibid.
267 Ibid. at p.242.
he deliberately neglects the fact that he had no right to make a demand.268 It also indicates that the court has the right to interfere in the underlying relationship of the parties merely on the ground of lack of the beneficiary's honest belief in the account party's default.

Despite the fact that the views of Hirst J. in Tukan Timber 269 and Lord Denning in State Trading Corporation 270 mitigate the hard line taken by other English courts in dealing with fraud, it is suggested, with all due respect to these decisions, that the beneficiary's "honest belief" criterion as a ground of interference should be applied with caution by the courts. The bank therefore should not be obliged to pay the letter of guarantee merely because of the beneficiary's "honest belief" of the account party's default. It is suggested that on the beneficiary's "belief" criterion of demanding the letter of guarantee may lead to situations where the account party has practically no defence against payment as long as the demand was made in accordance with the beneficiary's "honest belief" criterion. Whereas such a criterion may be misused by ill-fated beneficiaries, banks are required to adhere to their duties of proper examination of the beneficiary's demand so as to reduce the beneficiary's unfair calls. Accordingly, they should not let the beneficiary's "honest belief" be in itself a sufficient cause for payment.271 It seems that such difficulties had led the URDG to exclude the possibility of demanding

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the letter of guarantee according to the beneficiary's "honest belief". Art. 20(a) of the URDG provides:

"Any demand for payment under the Guarantee shall be in writing and shall (in addition to such other documents as may be specified in the Guarantee) be supported by a written statement (whether in the demand itself or in a separate document or documents accompanying the demand and referred to in it) stating:

(i) that the Principal is in breach of his obligation(s) under the underlying contract(s) or, in the case of a tender guarantee, the tender conditions; and

(ii) the respect in which the Principal is in breach".

Although this article could be criticized for making the bank's obligation to pay primarily based on the presentation of documents that emanate from the beneficiary alone, it does provide more security against fraudulent demands that are based on the beneficiary's "honest belief".

4.4 The Bank's Role In Preventing Fraud.

When it receives a demand for payment, the bank should react promptly in deciding whether or not to pay. Otherwise, recovery of any money once paid might be very difficult for many reasons including jurisdictional and exchange control regulations in the beneficiary's country. The bank, however, should not proceed to pay under a letter of guarantee if it does not receive a proper demand. Art. 2(b) of URDG explicitly obliges the bank only upon the receiving of a proper demand. The Article provides:

"[T]he duty of a Guarantor under a Guarantee is to pay the sum or sums therein stated on the presentation of a written demand


273 Pierce A., supra at p.224.
for payment and other documents specified in the Guarantee which appear on their face to be in accordance with the Guarantee."

Under a documentary letter of guarantee, the beneficiary is normally required to present certain document(s) to prove the account party's default.\textsuperscript{274} The bank accordingly is under a duty to examine all the documents presented in respect of payment, before proceeding to payment. It is therefore obliged to examine certain elements in the demand or the accompanying documents in order to ensure that they conform to the terms and conditions under the letter of guarantee. It is required for example to verify the court or arbitral tribunal decisions in terms of competence and finality, if such documents are required to be presented so as to support the demand for payment. If these documents appear on their face to conform to the terms and conditions of the letter of guarantee the bank should pay. Art.(9) of the URDG provides:

"All documents specified and presented under a Guarantee, including the demand, shall be examined by the Guarantor with reasonable care to ascertain whether or not they appear on their face to conform with the terms of the Guarantee. Where such documents do not appear so to conform or appear on their face to be inconsistent with one another, they shall be refused".

Fraud cannot be discovered easily by the banks. The English courts therefore believe that the bank has the right to pay and have the recourse to the account party or the instructing bank,\textsuperscript{275} as the case may be, after the proper examination of the documents. In the case of Edward Owen, Lord Denning noticed that banks are rarely in a position to know that the demand is fraudulent or dishonest, and therefore they have to pay the agreed amount.\textsuperscript{276}

\textsuperscript{274} Such documents may take the form of third party's certificate issued by an engineer, surveyor or an accountant.

\textsuperscript{275} Pierce A., supra, at pp.186-187.

\textsuperscript{276} [1978] All ER 976 at p.976.
The same approach was also adopted by Roskill L.J in *Howe Richardson*.

In this case the learned judge held that:

"The bank, in principle, is in a position not identical with but very similar to the position of a bank which has opened a confirmed irrevocable letter of credit. Whether the obligation arises under a letter of credit or under a guarantee, the obligation of the bank is to perform that which is required to perform by that particular contract, and that obligation does not in the ordinary way depend on the correct resolution of a dispute as to the sufficiency of performance by the seller to the buyer or by the buyer to the seller as the case may be under the sale and purchase contract; the bank here is simply concerned to see whether the event has happened on which its obligation to has arisen."\(^{278}\)

It may be argued that allowing the bank to interfere in the underlying relationship of the parties by examining the documents that prove the account party's default would undermine the principle of independence of the letters of guarantee.\(^{279}\) Nevertheless, linking the on-demand letter of guarantee with the underlying contract could have some advantage in reducing the number of fraudulent and unfair callings of the letter of guarantee by preventing the bank being obliged to pay on the beneficiary's demand alone.\(^{280}\) In *Esal (Commodities) Ltd v Reltor Ltd v Oriental Ltd and Wells Fargo Bank*,\(^{281}\) Ackner L.J said:

"The requirement that [the beneficiary] must, when making his demand for payment in order to support his request for an extension, also commit himself to claiming that the contract has

\(^{277}\) Supra. at p.161.

\(^{278}\) Ibid. at p.167.

\(^{279}\) Ibid. at 231.


\(^{281}\) [1985]2 Lloyd's Rep. 546
not been complied with, may prevent some of the many abuses of the performance bond procedure that undoubtedly occur.\footnote{282} The URDG adopted the right approach to prevent fraudulent demands and unfair callings of the letter of guarantee by requiring the beneficiary to support and justify his demand by a written statement. Art. 20 of the rules provides:

"(a) Any demand for payment under the Guarantee shall be in writing and shall (in addition to such other documents as may be specified in the Guarantee) be supported by a written statement (whether in the demand itself or in a separate documents accompanying the demand and referred to in it) stating:

(i) that the principal is in breach of his obligation(s) under the underlying contract(s) or, in case of a tender guarantee, the tender conditions; and

(ii) the respect in which the principal is in breach."

The URDG also recognises the importance of the account parties as the banks' main source of information in case of fraud. The bank therefore is required by Art.(21) of the URDG to transmit the beneficiary's demand on the letter of guarantee and any related documents to the account party. Such duty will, without doubt, contribute to reducing the possibilities of fraudulent or unfair demands by giving the account party the chance to challenge any fraudulent demand either directly to the bank or by obtaining an injunction against payment through the competent court.\footnote{283} The bank accordingly has to determine whether or not the facts and evidence of fraud are clearly established. To be able to reach such decision it has to examine the documents

\footnote{282} Ibid. at p.553.

\footnote{283} Art. (21) of the URDG provides "The Guarantor shall without any delay transmit the Beneficiary's demand and any related documents to the Principal or where applicable to the instructing party for transmission to the Principal". See also Lipton J., "Uniform Regulation of Standby Letters of Credit and Other First Demand Security Instruments in International Transactions", [1993] Journal of International Banking Law 402 at p.405.
presented by the beneficiary in order to check their conformity to the terms of the letter of guarantee. If the examination of the documents raises the bank's suspicions of fraud it has accordingly the right to inquire of the beneficiary and to give him the opportunity to answer. Based on the beneficiary's answer and the information available the bank should decide whether or not pay.

The notion of fraud raises more difficulties in the case of an indirect letters of guarantee where two banks are usually involved. In this case, the account party needs to double his efforts to prove fraud. On one hand the account party needs to prove fraud in the relationship between the correspondent bank and the beneficiary and in the bank's relationship with each other on the other hand. In the latter situation, the account party would be normally required to provide the court with clear evidence of a fraudulent demand of the issuing/correspondent bank against his bank. The correspondent bank's fraudulent demand may exist, for example, if it seeks reimbursement from the instructing bank despite the fact that payment of the letter of guarantee has been blocked by the courts in former's country.

Lack of privity between the account party and the correspondent bank may prevent him from restraining the correspondent bank from payment. It seems therefore that the only possible opportunity would be to seek an injunction to restrain his local bank from payment under the counterletter of

285 In the case of indirect guarantees the principal requests the first bank to instruct the second bank which is usually based in the beneficiary's country, to issue a guarantee in the latter's favour.
286 See Pierce A., supra, at p.47.
guarantee. It is suggested that such a problem could be avoided if the account party succeeds in persuading his counter party to accept a direct letter of guarantee issued by a bank in his country, regardless of the predictable opposition by the beneficiary.

4.5 Pleading Fraud.

To plead fraud by the bank or the account party, the pleader should set out all the facts, matters and circumstances he relies on to show that the beneficiary was acting with fraudulent intentions.

In practice, when the bank receives a demand from the beneficiary alleging the account party's default under the letter of guarantee, it normally delays payment and transmits the demand with the accompanying documents to the account party so as to give him the chance to prove that he had tried or intended to perform his obligations under the letter of guarantee. The bank then may turn to the beneficiary to face him with any information it may receive from the account party. The court would consider the beneficiary's demand as fraudulent if he fails to prove the account party's default when he is required to do so. In United Trading Corporation Ackner L.J stated that the court is entitled to draw an inference of guilt from the beneficiary's silence if he was given a fair and adequate time to answer a charge of fraud but he failed to do so. The learned judge said:

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"[W]e would also expect that the [beneficiary] to have been given an opportunity to answer the allegation and to have failed to provide any, or any adequate answer, in circumstances where one could properly be expected. If the court considers that on the material before it the only realistic inference to draw is that of fraud, then the [account party] would have made out a sufficient case of fraud".293

The judge's statement here seems to create a burden on the bank to inquire whether the underlying contract has been performed as the documents purport to say or not. It can hardly be realistic for the bank to make inquiries about the beneficiary's demand or to allow him to answer allegations of fraud made by the account party. One has to consider the expense and time such enquiries would involve. Howcroft criticised Ackner L.J's statement in the above mentioned case by pointing out that:

"How long should a bank allow for a response? If a response is received, presumably the bank must decide its adequacy, and perhaps consider whether it should ask for further information. If no response is received to the bank's enquiry, it is not conclusive that the allegation of fraud is correct, since Ackner L.J. also refers to corroborative evidence, and the question arises as to how strong that evidence needs to be. In any event, the buyer is under no obligation to submit, in effect, to the bank's jurisdiction and, in the meantime, the bank would clearly be in breach of the terms of a performance bond which provides for immediate payment."294

In effect the decision means that if the account party produces corroborated evidence showing that there was no default on his part and that the beneficiary has failed to respond to his enquiries where a response could reasonably be expected, the court should then grant an injunction if 'a realistic interference

293 Ibid., at p.554

of fraud could be drawn.' Ackner L.J.'s formulation could be also criticised on the ground that it does not provide any guidance on the standard required for convincing corroborative evidence, since the documents do not of themselves have to establish 'clear fraud'.

The evidence of fraud must be clear, both as to the fact of fraud and as to the bank's knowledge.295 Having "clearly established" the fraud, it is the duty of the account party to furnish the bank with knowledge of the fraud. Accordingly, the bank's knowledge of fraud has been always of particular significance to the English courts before an injunction to restrain the bank from payment is granted.

4.6 The Bank's Knowledge Of Fraud.

The timing of the bank's knowledge of fraud is considered a vital element according to the courts point of view. In Dodsal PVT Ltd v. Kingpull Ltd,296 Neill L.J said:

"The grounds upon which the court has contemplated that an injunction could be granted appear to have been limited to knowledge of fraud or lack of honest belief. There may be cases where no injunction could be granted against a bank because they had no reason to know of, or even suspect, any fraudulent conduct but where relief could be obtained against the beneficiary whose lack of honest belief in his right to make a claim could be clearly demonstrated. But the cases show that in the absence of bad faith, the bond or guarantee will be enforced." 297


297 Ibid. at p.95.
The fact that the bank is under no obligation into inquire in the underlying contract makes it very difficult to prove the bank's knowledge about fraud prior to payment.\textsuperscript{298} The bank is only required to judge the demand for payment and the accompanying documents so as to ensure that they conform with the letter of guarantee. Its task, however, does not extend to ensuring whether the account party's obligations have been properly performed or not. Banks are "rarely, if ever, be in a position to know whether the demand is honest or not. At any rate they will not be able to prove it to be dishonest. So they will have to pay."\textsuperscript{299}

The condition of the bank's prior knowledge of fraud may raise the question of what constitutes the bank's knowledge in the courts' view.\textsuperscript{300} It seems that the bank's knowledge is usually based on what the bank ought to know on the basis of clear information already available to it. It should not, therefore, be based on the account party's mere allegation of the beneficiary's fraud.\textsuperscript{301} But if the beneficiary's fraudulent demand was very hard to discover by the bank, it may still have the chance to recover any loss it may suffer as a result of payment.\textsuperscript{302} This point view is supported by Browne L.J in \textit{Edward Owen}.\textsuperscript{303} The learned judge held that:

"In my judgment, if the documents are presented by the beneficiary himself and are forged or fraudulent, the bank is

\textsuperscript{298} O'Donovan, \textit{The Modern Contract of Guarantee}, (1985) at p.608.

\textsuperscript{299} See e.g., \textit{Edward Owen Engineering Ltd v. Barclays Bank International}, supra, Per Lord Denning at p.983.

\textsuperscript{300} Bertrams R., supra, at p.307.

\textsuperscript{301} See Ackner L.J in \textit{United Trading Corp.v.Allied Arab Bank Ltd.}, supra, at p.560.


\textsuperscript{303} \textit{Edward Owen Engineering Ltd v. Barclays Bank International}, supra, at 982.
entitled to refuse payment if the bank finds out before payment, and is entitled to recover the money as paid under a mistake of fact if it finds out after payment."304

Browne L.J.'s approach could be criticised on the ground that the bank is not only "entitled" to refuse payment if the demand proved to be fraudulent it is rather obliged to do so.305 The courts will normally uphold the bank's right to be reimbursed unless clear fraud was brought to the latter's attention before payment.306 Thus, the bank's responsibility arises if it is proved that at any time prior to actual payment, the bank was or must have been aware of the fraudulent demand.307 If it paid despite its knowledge of fraud, the bank may be held liable for tort of negligence and may be denied the right to be reimbursed by the account party.308 This will indeed help the integrity of the letters of guarantee system as an acceptable means of security in international commerce.309

The constancy or suitableness of resort to enjoining payment under letters of guarantee and standby letters of credit has engendered controversy in the banking business and among academics.310 The controversy stems from the contradiction between the restraining orders and the principle of independence of the banks' obligation to pay under both the letters of guarantee and the standby letters of credit. There is no doubt that the bank's suspicions of fraud place it in a very critical situation. On the one hand, it

304 Ibid. at p.985.
305 See United Trading Corp. v. Allied Arab Bank Ltd., supra, at p.560.
306 Jack R., supra. at p.221.
309 Ibid., at p.199.
would be held liable for wrongful dishonour to the beneficiary or the issuing/correspondent bank, as the case may be, if it refuses to pay. On the other hand, it may be held liable for damages to its customer if it paid where it should not have done so. Suspicious alterations or obliterations in the demand or the accompanying documents should put the bank on guard and it should scrutinise carefully all the documents to ensure that they comply with the requirements of the letter of guarantee. English courts have always emphasised that strong suspicions of fraud by the bank are not sufficient to stop payment. The evidence of fraud should be always very clear. In order for an injunction to be granted, fraud must be proved and not based on mere allegations, suspicion or possibility. The bank, therefore, cannot delay payment upon its customer's mere allegations of fraud which might turn out to be false and could lead to it being held responsible for the beneficiary's damages. In United Trading Corporation S.A. v. Allied Arab Bank the Court of Appeal ruled that general allegations of fraud are insufficient to stop the bank from paying the beneficiary. When evidence of beneficiary's fraud is obtained by the bank it is for the bank alone to evaluate the evidence of fraud. The account party should not be allowed to assess the evidence of fraud on the bank's behalf.

The account party, on the other hand, is rarely in a position to present a strong corroborative evidence of fraud to his bank. All this makes the account party's task to prove the bank's knowledge of fraud very difficult and

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314 Pierce A., supra, at p.199.
315 Ibid. at p.197.
leaves him suffering the inevitable loss if payment by the bank is made.\textsuperscript{316} It follows that, in most cases, the letter of guarantee would be paid before the account party could succeed in proving a case of an established fraud and a bank's knowledge of it.\textsuperscript{317}

### 4.7 The Court's Role In Preventing Fraud

It has been stated that when the account party agrees to be involved in a letter of guarantee transaction he should bear in mind the possibility of a fraudulent demand by the beneficiary.\textsuperscript{318} He should not overestimate his relation with the beneficiary by relying on his probity in not calling the letter of guarantee without justification,\textsuperscript{319} otherwise "there would be little need for performance guarantees at all".\textsuperscript{320} In \textit{R.D Harbottle (Mercantile) Ltd v. National Westminster Bank Ltd},\textsuperscript{321} Ackner L.J., noticed that:

"...In effect, the sellers rely on the probity and reputation of their buyers and on their buyers and good relations with them".\textsuperscript{322}

Repeated fraudulent attempts to call the letter of guarantee by the beneficiary raise the question of whether or not the bank's duty to pay remains valid towards the end of the date of expiry of letters of guarantee. It is believed that the single fraudulent attempt to demand the letter of guarantee would not

\footnotesize{\textsuperscript{316} Bertrams R., supra, at p.307.}

\footnotesize{\textsuperscript{317} Ellinger E., "Fraud in Documentary Credit Transaction" [1981] \textit{Journal of Business Law} 258 at p.262.}

\footnotesize{\textsuperscript{318} Coleman M., "Performance Guarantees" [1990] \textit{Lloyd's Maritime and Commercial Law Quarterly} 223 at p.237; and see also Blau W., and Jedzig J., "Bank Guarantees to pay upon First Written Demand in German Courts"[1989] \textit{International Lawyer Journal}, 725 at p.727.}

\footnotesize{\textsuperscript{319} White K., supra, at p.126.}

\footnotesize{\textsuperscript{320} Lawson M., supra, at p.260.}

\footnotesize{\textsuperscript{321} Supra, at 146.}

\footnotesize{\textsuperscript{322} Ibid. at p.150.}
absolve the bank from its obligation to pay and will keep it obliged to pay as soon as it receives a subsequent proper demand.

It may be concluded that in spite of the recent decisions of English courts regarding letters of guarantee, which undoubtedly have contributed to the development of English law relating to fraud, it seems that this area is still vague and obscure \(^{323}\) and that little attention has been paid to the analysis of fraud concept.\(^{324}\) So far, no clear definition of what may constitute fraud has been given by the courts. It is expected that the notion of fraud might be applied less stringently in the future by English courts in the case of letters of guarantee, and accordingly the onus of proof borne by the account party will be reduced.\(^{325}\)

### 4.8 Restriction of Payment on Account of Fraud Committed by a Third Party.

The characteristics of the fraud exception in the letter of guarantee could be the same characteristics that were discussed in the landmark case of *United City Merchants Ltd. v. Royal Bank of Canada [The American Accord]*\(^ {326}\) where in October 1975, Glass Fibres and Equipment Ltd., a U.K. company, contracted with Vitro of Lima, Peru to build a glass fibre plant and supply certain other machinery for the latter. An irrevocable, transferable letter of credit was opened by Banco Continental of Peru and confirmed by the Royal Bank of Canada of Montreal. The terms of payment under the credit

\(^{323}\) Jack R., *Documentary Credits*, supra, at p.189.

\(^{324}\) An example of the English courts' attempts to set out a definition on the elements of fraud in the common law could be concluded by the ruling of Parker J in *GKN Contractors LTD v Lloyds Bank p/c* [1985] 30 B.L.R. 48 where he said that "fraud" could be committed by the beneficiary when he presents a claim which he knows at the time to be invalid claim.


stipulated three installments. 20% of the total price was payable on agreements; 70% was payable upon tender of the shipping documents and 10% was payable on completion. In July 1976, Glass Fibres, assigned their rights, entitlements and benefits under the credit to United City Merchants (Investments) Ltd. as security of advances.

The letter of credit called for a bill of lading showing shipment not later than December 15, 1976. However the goods were actually on board the American Accord on 16th of December, just one day later. The shipping agent, without notifying the beneficiary or his assignee, and with the intention of avoiding the issue of non-conformity as to documents, issued a bill of lading duly signed with the notation that the goods were actually on board the American Accord on 15th of December. Also, contrary to the credit terms the goods were shipped from Felixstowe and not London. On presentation of the documents by United City Merchants, the confirming bank refused to pay. Hence the action.

The issue raised before the court was whether to hold the beneficiary responsible for forged documents of which he has no knowledge. The confirming bank argued, in the court of first instance before Mocatta J., that a confirming bank is not bound to pay the beneficiary of a documentary credit or his assignee the sum indicated in the credit if the tendered documents, though conforming on their face with the credit terms, contain some statement of material fact that is not accurate. Mr. Justice Mocatta expressed the opinion that the fraud exception could only be invoked against the beneficiary if he knew about the inaccuracy of the documents before their tender. However, the Court of Appeal inclined to another view that the fraud exception may be applied to any document containing a material inaccuracy known to its maker, even if the beneficiary has no knowledge of it. The rule
of the Court of Appeal encompasses fraud committed by a third party. In the words of Ackner J. "a fraudulently completed document can not be a conforming document." When the case went to the House of Lords, it unanimously reversed the ruling of the Court of Appeal. It ruled that the fraud exception should be applied when the presented documents showed inaccuracy known to the beneficiary, otherwise the whole system of financing international trade by means of documentary credit would be undermined.

In effect the House of Lords narrowed the scope of the fraud exception to make it in accord with the rule of independence of the letter of credit from the underlying sale transaction. In the words of Lord Diplock:

"We are dealing only with a case in which the seller-beneficiary claiming under the credit has been deceived, for, if he presented documents to the confirming bank with knowledge that this apparent conformity with the terms and conditions of the credit was due to the fact that the documents told a lie, the seller beneficiary would himself be party to the misrepresentation made to the confirming bank by the lie in the documents and the case would come within the fraud exception, as did all the American cases referred to as persuasive authority in the judgments of the Court of Appeal in the instant case."328

It is contended that the House of Lords decision in the United City Merchants, places the bank in a very delicate, vulnerable situation. A bank has to honour drafts drawn under a credit, even if it knows that the tendered documents, though regular on their face, were fraudulent or forged. Under these circumstances, the account party may sue the bank alleging breach of

327 For discussion of the case see Merkin R., "International fraud and documentary credit" [1982] 4 Liverpool Law Review p.76

contract on the ground that the bank made payment against documents which he knew were forged or fraudulent.

Due to these considerations, this decision was subjected to criticism. Professor Schmitthoff takes the view that: "This strict interpretation, though in accordance with principle, will cause unease in international banking circles. It creates a very uncomfortable situation. Banks will not like the idea that they have to honour a credit although they know that the documents tendered are fraudulent, only because it can not be proved, before the credit is honoured, that the seller was aware of the fraud. Banks will continue to treat such documents with the greatest circumspection lest it can be alleged that they have acted without reasonable care."329 Professor Goode expressed the view that a bank should refuse to honour the drafts drawn against a fraudulent document, irrespective of who committed the fraud, that "the beneficiary has a duty to tender documents which are in order, and the fact that he acted in good faith in tendering forged documents is thus irrelevant. The beneficiary under a credit is not a holder in due course of a bill of exchange, he is only entitled to be paid if the documents are in order. A fraudulently completed bill of lading does not become a conforming document merely because the fraud is that of a third party."330

It is suggested that on the merits of the case, the decision of the House of Lords and the analysis adopted by Lord Diplock seems more plausible. If the fraud exception is given a wide latitude of judicial discretion, it is more apt to undermine the structural rule of the credit independence from the underlying transaction. The beneficiary should be responsible if he shuts his


eyes to a document presented by him to the bank which he would have known to some extent was fraudulent by giving it closer consideration. The bank should not be left in this delicate situation if it pays despite the fraud.

4.9 Fraud In Standby Letters of Credit.

Fraud as a defence against payment under standby letters of guarantee has also been recognised by the American courts. The pre-Uniform Commercial Code (UCC) case of Sztejn v. Schroeder 331 is considered as the starting point in dealing with fraud in standby letters of credit in the United States. In that case the American plaintiff had contracted to purchase a quantity of bristles from a seller in India and had arranged to pay the seller by means of a letter of credit issued by the defendant bank (Schroeder). Accordingly, the seller drew a draft payable to its Indian bank (collection agent) and delivered the draft and accompanying documents to the bank for collection for the seller's account. The Indian bank, in turn, presented the draft and documents to the defendant bank for payment under the documentary letter of credit. The plaintiff meanwhile discovered that, although the documents properly described the bristles ordered, the seller, in reality, had shipped fifty crates with cow hair and other worthless material and rubbish.

Thereupon, the Indian seller drew a draft along with the fraudulent documents to the order of the advising bank for collection. The tendered documents were regular and conforming on their face. Upon presentation of the documents, the plaintiff raised an action for an injunction relief on the ground that the letter of credit and the draft drawn thereunder were void.

Shientag J. was faced by the legal principle that an irrevocable letter of credit is independent from the underlying sale contract and that the issuing bank's concern is with regular, conforming documents rather than the goods.

331 177 Misc. 719, 31 N.Y.S. 2d 633 (Sup. Ct. 1941)
Nonetheless, the learned judge approached the issue from a different perspective. He said:

"However, I believe that a different situation is presented in the instant action. This is not a controversy between the buyer and the seller concerning a mere breach of warranty regarding the quality of the merchandise; on the present motion, it must be assumed that the seller has intentionally failed to ship any goods ordered by the buyer. In such a situation, where the seller's fraud has been called to the bank's attention before the drafts and documents have been presented for payment, the principle of the independence of the bank's obligation under the letter of credit should not be extended to protect the unscrupulous seller. It is true that even though the documents are forged or fraudulent, if the issuing bank has already paid the draft before receiving notice of the seller's fraud, it will be protected if it exercised reasonable diligence before making such payment."332

The court's decision in the above mentioned case is to be considered the first of its kind in accepting fraud as an exception to the principle of the independence of contracts in documentary credits in the U.S.A. This case indicates that a letter of credit could be vitiated by proof of actual fraud. It sets out the rule that a bank need not accept a tender of documents it knows to be fraudulent. The rule is a difficult one to apply, for apart from the problems of proving fraud, there is the added difficulty of deciding what amounts to sufficient knowledge of the fraud on the part of the bank. Should the allegations made by the account party to the bank to be taken as true without more evidence? Surely if this were the case, the account party could at any time undermine the very purpose of the standby letter of credit by making an allegation of fraud on the part of the beneficiary.

332 Ibid.
Section 5-109 of the American Uniform Commercial Code is considered as a codification of the principles established by Sztejn case. This section provides:

"(a) If a presentation is made that appears on its face strictly to comply with the terms and conditions of the letter of credit, but a required document is forged or materially fraudulent, or honor of the presentation would facilitate a material fraud by the beneficiary on the issuer or applicant:
(1) the issuer shall honor the presentation, if honor is demanded by (i) a nominated person who has given value in good faith and without notice of forgery or material fraud, (ii) a confirmer who has honored its confirmation in good faith, (iii) a holder in due course of a draft drawn under the letter of credit which was taken after acceptance by the issuer or nominated person, or (iv) an assignee of the issuer’s or nominated person’s deferred obligation that was taken for value and without notice of forgery or material fraud after the obligation was incurred by the issuer or nominated person; and (2) the issuer, acting in good faith, may honor or dishonor the presentation in any other case".

The Article clearly recognises that fraud may relate to the underlying transaction. It implicitly gives the court the right to examine the underlying transaction when there is an allegation of fraud. The Article also sets forth that "material" evidence of fraud should be shown to the court before it could restrain the bank from payment. Under this standard the court should not grant injunctive relief unless it was proved by the account party that the beneficiary has no "colorable right" to draw under the standby letter of credit. This standard may be illustrated by the case of Itek Corp. v. National Bank of Boston.333 In this case the plaintiffs entered into a contract with the Ministry

of War of Iran to supply the latter with optical equipment worth $22.5 million. Against a down payment of $6.25 million, the plaintiffs procured a guarantee issued by Bank Melli of Iran, secured by a letter of credit issued by the defendants. The plaintiffs performed a portion of the contract more than the value of the down payment. However, due to cancellation of their export license in early 1979, they were unable to complete performance. The Ministry of War, made demand on the letter of guarantee, and in turn the Bank Melli made demand on the letter credit issued in their favour. The court granted an injunction against payment on the ground that the beneficiary has no "colorable right" to draw under the standby letter of credit.334

The American courts also consider the situation where the beneficiary has "no basis" to make a demand on the standby letter of credit as a material evidence of fraud which could justify the bank's refusal to pay. In *Dynamics Corp. of America v. Citizens and Southern National Bank*,335 for example, the plaintiffs' company agreed to sell defence-related communications equipment for some $1.368 million, to the government of India. The Agreement obligated the plaintiffs both to deliver the equipment FOB its factory and to provide technical assistance and know-how to India. Payment to the plaintiff company was structured on a credit arrangement between India and the U.S.A., whereby the U.S Government agreed to effect payment to the plaintiffs on the presentation of India's invoices accompanied by a required statement as to particular facts. In pursuance of the contract, the plaintiffs produced an irrevocable letter of credit in favour of the Indian government authorising India to demand payment upon submission of a certificate to the

334 Ibid. at p.1350.

effect that the plaintiffs had failed to perform their contractual obligations. Afterwards India entered into war against Pakistan. Thereupon President Nixon announced a partial embargo of military supplies directed to India. Hence India refused to certify any invoice for payment and moved to demand payment under the standby letter of credit. The plaintiffs raised a claim seeking to enjoin the bank from paying, on the ground that it was the embargo and not the plaintiffs which caused the default. They contended that, in fact, they did supply the equipment FOB their factory, however the embargo prevented India from shipping the equipment abroad. Under the circumstances, India's certification to the contrary and demand for payment was fraudulent. The court found it difficult to apply the rules on fraud in a situation involving intergovernmental relations. However, the court ruled in favour of the plaintiffs on the ground that "An injunction the bank would merely require to continue holding on to the deposit. If the plaintiff's application were denied, the deposit would be on its way to India as would plaintiff's remedy, and plaintiff, which has already filed in bankruptcy, would be severely disadvantaged. It would not appear that India would be seriously disadvantaged by some further delay and the entry of a preliminary injunction. It appears to the court that plaintiff has at least a decent chance of winning this suit, and there is as much public interest in discouraging fraud as in encouraging the use of letters of credit. Accordingly, the court concludes that a preliminary injunction is warranted."336

Evidence of material fraud could also be found according to the American courts if the beneficiary's wrongdoing under the standby letter of credit has "vitiated the entire transaction".337 In Intraworld Industries, Inc. v.

336 Ibid. at pp. 999-1000.
Girard Trust Bank 338 a Swiss citizen, leased a Swiss hotel to Intraworld, a Pennsylvanian corporation. Pursuant to the lease terms, Intraworld obtained standby letters of credit from the Girard Trust Company of Philadelphia (Girard) to secure rental payments for one year in advance. The credits authorised the lessor to draw upon presentation of documents that included a signed statement "that the drawer is the lessor under said lease and that the lessee thereunder has not paid the installment of rent due under said lease.....within 10 days after said installment was due and payable."

A demand on one of the standby letters of credits was made by the beneficiary. On the other hand, Intraworld brought an action to enjoin payment under the standby letter of credit on the grounds of fraud. The trial court denied the injunction, and Intraworld appealed to the Pennsylvania Supreme Court. The court affirmed the trial court’s denial of the injunction. It was held by the court that:

"[W]e think that the circumstances which will justify an injunction against honour must be narrowly limited to situations of fraud in which the wrongdoing of the beneficiary has so vitiated the entire transaction that the legitimate purposes of the independence of the issuer's obligation would no longer be served." 339

What amounts to fraud that justifies the issuing of an injunction against a paying bank under a standby letter of credit is a controversial point. 340 Some commentators would construe fraud as it is known in tort and general contract


339 Ibid. at p.324.

law. Others advocate a standard designed specifically for standby letters of credit. Harfield, for example, has argued that an injunction should be available only if the beneficiary has committed "egregious" or "gross" fraud. This means fraud that infects the entire transaction. Ellinger on the other hand suggests that the issuing bank should be enjoined only if the beneficiary acts "without an honest shred of belief in his right to payment." By this standard, the beneficiary's demand would not be deemed fraudulent if a genuine controversy exists as to who, as between the account party and the beneficiary, is in breach of the underlying contract. Symons suggests yet another standard. He argues for issue of an injunction if there is "intentional fraud" on the part of the beneficiary. This standard, Symon argues, derives from a careful reading of the Sztejn case and the common duty of good faith among contractors who are subject to the UCC. He further argues that no contracting party consents to an act of dishonesty, even if it is to take advantage of standby letter of credit mechanism. The bottom line of this argument is that an injunction should be issued if the beneficiary has no

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341 E.g., Symons E.L., supra, at p.338.


343 Ibid., at pp. 614-5.

344 Ibid., at p. 608.

345 Ellinger E.P.; "Fraud in Documentary Credit Transactions", supra, at p.258.

346 For such a state of affairs, see Penn. State Const., Inc. v. Cambria Savings Assn., 519 A 2d. 1034 (1987) where the applicant failed to complete the project on time, but argued that the beneficiary was not entitled to payment under the standby credit because the default had been caused by the beneficiary's delay in making requisition payments.

347 Symons E.L., supra, at p.340

348 The "good faith" he invokes is that in the UCC s.5-102(7) which means honesty in fact in the conduct or transaction concerned. Ibid., at 349.
"honest" belief in the truth of his demand."\textsuperscript{349} This demand is more relaxed than that suggested by Professor Ellinger.

The elements of fraud are threefold:
(1) the perpetrator makes a material misstatement of fact with the intention of misleading the victim
(2) the victim justifiably relies on the misstatement, and
(3) the victim incurs damages as a result of that reliance.

Art. 5-109 of the UCC also shows that the bank may either honour or dishonour when there is fraud or forgery. The distinction between forged and fraudulent documents seems to be well established.\textsuperscript{350} The outer limit of "fraudulent documents", however, is not clear. It is fairly certain that a document which deliberately misstates the true state of affairs is fraudulent.\textsuperscript{351}

In standby letter of credit cases, such a document would likely be encountered where there is a "tying" of the standby letter of credit documents with the underlying transaction.\textsuperscript{352} This happens when documents in the standby letter of credit transaction are required to state that particular condition in the underlying transaction have been fulfilled. If these documents make deliberate misstatements on the pre-conditions, they would qualify as fraudulent documents. It would also appear that if a draft is supposed to be

\textsuperscript{349} The test is subjective: Ibid., at 340. Symons equates fraud with the tort of deceit. According to him, an injunction should issue if (the beneficiary) "(a) knew that his statements were untrue, or (b) knew that he did not know whether they were true or false, and thus made the statements in reckless disregard of their truth or falsity." Ibid., at p. 345.

\textsuperscript{350} Compare The American Accord, supra, involving a deliberate backdating of a document (forgery) with Sztejn v. Schroeder 177 Misc. 719, 31 N.Y.S. 2d 633 (Sup. Ct. 1941) involving a deliberate misdescription of the worthless goods shipped (fraud).

\textsuperscript{351} Sztejn v. Schroeder 177 Misc. 719, 31 N.Y.S. 2d 633 (Sup. Ct. 1941).

drawn in accordance with the standby letter of credit and it is drawn for another purpose, even though it may be a facially complying draft, it is a fraudulent document.353 This is because the beneficiary intentionally presents a deceitful document when demanding payment.

There is a temptation by the American courts to look at the underlying transaction either to discover the purpose of the standby letter of credit or to verify the delivered facts when the court is faced with an allegation of a fraudulent document under the standby letter of credit. In general, such temptation is opposed by some commentators as it violates the autonomy principle of the standby letter of credit. Any reference in the standby letter of credit to the underlying transaction should be ignored when assessing performance on the standby letter of credit.354 Further, an inquiry into the underlying transaction changes the fundamental nature of the standby letter of credit which is supposed to guarantee prompt payment to the beneficiary and leave the parties to litigate their differences later on. Dolan, an American commentator, argues that courts should entertain only those claims of fraud that can be expeditiously resolved without an inquiry into the underlying transaction.355 He contends that as the standby letter of credit is intended to ensure swift payment to the beneficiary, any inquiry into the underlying transaction would destroy its fundamental nature.356

353 The materiality of the purpose of a letter of credit was stressed in Bank of Newport v. First National Bank of Bismark 687 F.2d. 1257 (8th Cir., 1982) where the court held there was fraud in the transaction on the basis of the purpose of the letter of credit.

354 Art. 2 of the URDG.

355 See Dolan J.F.; supra, at p.22.

356 Dolan J.F., Ibid. Further, Kurkela argues that different standards of fraud should be applied for commercial and standby credits. He argues that as a commercial letter of credit constitutes part performance of the underlying contract, a fraud inquiry in the letter of credit may involve the underlying transaction with justification. (But see Geva B., "Contractual Defences as Claims to the
Nonetheless, it appears that, on the whole the standard of proof in respect of fraud is less exacting than in England. By comparison, American courts allow a more in-depth and protracted investigation into the underlying transaction, for example by further a hearing with the attendant delays, whereas in England the party alleging fraud must produce the evidence immediately, without such lengthy and thorough investigation. Moreover, the criterion of 'irreparable harm' and 'the balance of convenience' do not play a part in English proceedings for preliminary injunctions. In addition to this material standard the account party must prove that he will be irreparably harmed if the injunction is denied because he has no other adequate remedy at law. But because the account party can generally sue the beneficiary for money damages resulting from breach of the underlying contract, he will not usually be able to meet this burden. The courts accordingly have shown a reluctance to grant an injunction to restrain the bank from payment, even if clear fraud on the part of the beneficiary was shown by the account party, if damages will be an adequate remedy for any breach of duty by the bank.\(^{357}\)

This means that the court prefers to not to interfere. It would instead let the bank honour its obligation to pay despite the account party's objections of fraudulent demand and it would let him seek proper compensation if a wrongful honouring by the bank is proved. In the case of Xantech Corp. v. Ramco Industries, Inc.\(^{358}\) the dispute involved modifications to the underlying instrument: The right to Block Payment on a Banker's Instrument"[1979] 58 Oregon Law Review. 283 at pp.288-92. where it is argued that the letter of credit and the underlying transaction should always remain independent of each other). However, since the purpose of a standby letter of credit is different from performance on the underlying contract by either the applicant or the beneficiary, any inquiry into fraud should be limited to the letter of credit transaction. See Kurkela M., Letters of Credit under International Trade Law (1985) at p. 193.

\(^{357}\) Goldsmith, M.E., supra, at p.154.: Jack R., Documentary Credits, supra, at pp.245-6.

\(^{358}\) 643 N.E.2d 918 (Ind. Ct.App.1994)
The appellate court held that the trial court should have denied the injunction because the applicant's ability to sue the beneficiary for breach of the contract afforded the applicant and adequate remedy at law.\(^{359}\)

The Article also provides that relief is available not only when there is forgery or fraud in the required documents but also when "honour of the presentation would facilitate a material fraud by the beneficiary on the issuer or applicant". This shows that relief from fraud is available when the location of the fraud is the underlying transaction. It seems therefore that the independence principle is not an obstacle under Art. 5-109. The courts are free to interfere in the underlying transaction in order to uncover the fraudulent conduct. By doing so the court can determine whether a document is fraudulent or the beneficiary has committed fraud and, if so, whether the fraud was material, i.e. very clearly established. It must be concluded that the requirement of materiality and the conditions for obtaining an injunction in the Article should make injunctive relief more difficult to obtain.

Despite the similarities between standby letters of credit and letters of guarantee, the former are still governed by the UCP which are mainly designed to regulate ordinary commercial letters of credit. It has been previously stated that there is a difference in the way both instruments function in the banking business. Such differences would make it difficult to apply the same rules to regulate the two.\(^{360}\) Nevertheless, in accordance with the current situation standby letters of credit will continue to be governed by the UCP. According to the UCP the bank has a duty to examine the


\(^{360}\) See Horn N. and Wymeersh E., supra, at p. 60.
documents within seven banking days following the day of receipt.\textsuperscript{361} There is no doubt that imposing such a duty on the bank will contribute to the reduction of unnecessary delay in payment which was the practice under the previous UCP.\textsuperscript{362} Such a limitation of time, however, should not put pressure upon the bank to decide whether or not to pay in a way that could prevent it from discovering fraudulent or unfair calling of standby letters of credit.

The Uncitral Convention puts forward some standards on fraud that could absolve the bank from payment under the letter of guarantee. Art. 19/1(a) of the Uncitral Convention absolves the bank from the duty to pay under the standby letter of credit or the on-demand letter of guarantee if upon "clear" and "manifest" standard it has noticed that any document presented for payment was "not genuine or has been falsified".\textsuperscript{363} The Bank is also excused from payment, if it finds out that no payment is due on the basis declared in the demand and/or the supporting documents.\textsuperscript{364} The bank is also absolved from payment if on the basis of the type and the purpose of the letter of guarantee, the demand has no possible basis.\textsuperscript{365} A typical example of this situation would take place if a demand for payment on a performance letter of guarantee was made on the ground of the account party's default despite the fact that performance of the contract has not yet started. The demand would also have no conceivable basis, according to the rules, if the risk against which the letter of guarantee was issued clearly did not exist. Or where the

\textsuperscript{361} See UCP Article (13).

\textsuperscript{362} According to Art. 15 of the UCP 400 the bank was not restricted by a limited time to finish the examination of the documents.

\textsuperscript{363} Art. 19/1 (a) of the Uncitral Convention.

\textsuperscript{364} Art. 19/1(b) of the Uncitral Convention.

\textsuperscript{365} Ibid. Article 19/1(c).
underlying obligation of the account party has been declared invalid by a court or arbitral tribunal, unless the undertaking indicates that such incident falls within the risk to be covered by the bank's undertaking. The bank is also under the duty to refuse to pay if it is proved that the secured obligation has been adequately performed by the account party. According to the Convention the bank is under the duty of refusing payment if it is proved that the beneficiary's deliberate misconduct was behind the account party's prevention of fulfilling his obligations under the letter of guarantee. This can be proved, for example, if the beneficiary deliberately refuses to provide the account party with the information and instruments that are necessary to complete the construction project or if the beneficiary fails to pay advance instalments on the contract price to enable the account party to start to perform his obligations.

It can be seen that all the standards provided by the Uncitral Convention have followed the English courts' criterion of accepting fraud as a defence against the bank's obligation to pay under the letters of guarantee. The Convention explicitly requires a "clear establishment" of fraud so as to stop the bank from payment. The Article could be criticised on the basis that it ignores the principle of autonomy which provides for the separation between the bank's obligation to pay and the underlying contract and for limiting the possible types of fraud to those mentioned in the article, which implicitly excludes other possible types of fraud from being an acceptable defence against the bank's obligation to pay.

366 Art. 19/2(c) of the Uncitral Convention.
367 Ibid. Article 19/2(c).
368 Ibid. Article 19/2 (d).
4.10 THE EFFECT OF INJUNCTIONS ON THE BANK’S OBLIGATION TO PAY

If it appears to the account party that the beneficiary is going to make or has made a fraudulent demand which he should not make or has made a presentation under the letter of guarantee which he should not make and which should not be met with payment by the paying bank, he may seek to prevent the presentation or payment or both by applying for injunctions against the relevant parties. Such an application will meet a number of difficulties. To begin with, he must show that he has a good arguable claim against the party he is seeking to enjoin. This will involve him establishing a case of fraud to the knowledge of the party to be enjoined, and a duty owed to him by that party, either in contract or in tort.

An injunction is issued by a court which has authority to issue injunctions in respect of matters within its jurisdiction. There are many types of injunctions, and terminology and procedure differ among jurisdictions. For example, the stages involved in obtaining an injunction restraining a bank from paying on a standby letter of credit in the United States are that one first obtains a temporary restraining order (TRO) or a preliminary injunction, and may thereafter get a permanent injunction. In England one may get first an ex parte injunction which may be interim or interlocutory. Alternatively, the injunction may be an interim injunction that is operative for only a specific period of time, and expires unless renewed. An interlocutory injunction on the

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369 A preliminary distinction should be made between "mandatory" injunctions which impose a positive duty to act, and "negative" injunctions which prohibit the doing of an act. This study focuses on the latter.

370 An ex parte injunction can only be granted in circumstances where it is impossible to give notice to the defendant to appear and defend the action, and where any delay would defeat the purpose of the injunction.
other hand is indefinite as to time and remains valid until it is discharged or the case is tried on the merits or is otherwise disposed of. One may also get a permanent injunction. Its effect is to settle permanently the relations at issue between the litigants. Despite terminological and procedural differences, courts in Anglo-American jurisdictions generally grant two main types of injunction: the temporary and the permanent. Further, despite differences over what a plaintiff must prove before his action succeeds, there are remarkable similarities. Generally, the plaintiff must prove that he will be irreparably harmed if the injunction is not granted, a likelihood of success on the merits of the case and that the balance of hardships clearly favours him.371

The injunction predates letters of guarantee. It has, however, become useful in practice so as to prevent banks from paying beneficiaries who make a demand for payment in circumstances where they should not.372 The ground advanced for seeking this remedy has normally been fraud by the beneficiary.

The general rule in Anglo-American jurisdictions has been to allow banks to honour their commitment to pay letters of guarantee/standby letters of credit and leave disputes on the underlying contract to be litigated between the parties. There are two reasons for this rule. First, courts try to enhance the utility of letters of guarantee and standby letters of credit by making them the means of effecting quick payment. They achieve this by enforcing the autonomy principle which dictates that matters in the underlying transaction should remain separate from those in the letter of guarantee. Secondly, courts


require strict proof of the prerequisites for obtaining injunctive relief. In practice, applicants find it hard to prove that they will be irreparably harmed if the injunction is not granted, or that they have no adequate remedy at law. The former is difficult to prove as the usual loss an account party will suffer is financial, and this can be compensated by an award of damages. The latter is virtually impossible to prove unless it is almost impossible to bring an action against the beneficiary. Further, one U.S. case has decided that an applicant has an adequate remedy at law (against the bank) if payment is made against non-complying documents. Consequently, the application of letter of guarantee law together with the tough prerequisites for injunctive relief make the injunction remedy a rarity. A more detailed analysis would reveal some differences between jurisdictions, and even within jurisdictions depending on the period of time, and on the rate of success in obtaining injunctions. However, the general rule remains that injunctions to restrain payment on letters of guarantee and standby letters of credit are rare.

The bank or the beneficiary normally appeals from the preliminary/interlocutory injunction if the letter of guarantee has not expired. On such appeal, evidence is adduced on the merits of the case. More often than not, the injunction is discharged. The usual ground for the discharge is that the plaintiff has an adequate remedy at law. This element is difficult to

373 See for example, KMW International v. Chase Manhattan Bank, N.A. 606 F.2d 10 (2nd Cir. 1979). With regard to the English law see, e.g., Fellinger G. A., supra, at 18, See Discount Ltd. v. Barclays Bank Ltd [1975] 1 All E.R. 1071, where Megarry J. in referring to the irreparable injury standard stated that the applicant's real claim in that case was for breach of contract and there was no suggestion that the defendant would not be able to pay. In Edward Owen Engineering Ltd v. Barclays Bank International Ltd., supra, 981, the contract referred all disputes to the Libyan courts and the applicants, anticipating the need to show irreparable harm, argued that no practical remedy was available to them in that forum.

374 Ibid.

prove, with the effect that permanent injunctions are virtually non-existent in letters of guarantee litigation. As a practical matter, the permanent injunction hardly comes into issue because the standby letter of credit will normally expire during the pendency of the interlocutory/preliminary injunction.

In general, the American courts have shown a variable tendency towards injunction against payment. On one hand, the courts agreed to grant an injunction against payment in some cases.\textsuperscript{377} The courts on the other hand sometimes denied the applications for injunction on the ground that the applicant failed to show an actual irreparable harm.\textsuperscript{378}

Some Iran-U.S. standby letter of credit cases, brought into use the "notice" injunction. The plaintiffs in these cases (mostly American corporations) applied to U.S. courts for injunctions before the beneficiaries made demand for payment under the credits. Their main argument was that the politically unstable conditions then prevailing in Iran could lead to

\textsuperscript{376} Keefe, supra, at p.11.


\textsuperscript{378} \textit{Recon Optical, Inc. v. Government, v. Government of Israel} 816 F.2d 854 (2d Cir. 1987); \textit{In Foxboro Co. v. Arabian American Oil Co.}, 805 F.2d 34 (1st Cir. 1986) (The court of Appeal was of the opinion that "an injunction to impede the honoring of a letter of credit is an extraordinary remedy that should rarely be granted); see also \textit{In Intraworld Industries, Inc. v. Girard Trust Bank} (461 Pa. 343, 336 A.2d 316, 17 UCC 191 (1975}) the court denied the application for injunction on the basis of independence from the underlying contract and accepted that the injunction should be granted in a very limited cases based on fraud.
fraudulent demands on the standby credits that had been issued on their account.\textsuperscript{379} It was claimed that during the political turmoil in Iran, unauthorised individuals could get access to banks and government departments and make demands on the credits. The courts were therefore asked to order the American banks to give notice to the applicants if any demand for payment was received, so that the applicant could verify its authenticity.\textsuperscript{380} If it appeared unauthorised or otherwise fraudulent, the particular applicant could apply for the injunction. Some courts in these cases granted the "notice" injunction, ordering the American banks concerned to give the applicants notice of any demand for payment on the standby letters of credit, and to wait for some time (10-15 days) before effecting any payment.\textsuperscript{381}

The "notice" injunctions were the first of their kind. They provided an effective remedy in a situation riddled with abuse, and where the plaintiffs appeared not to have an effective remedy against the beneficiaries, as the alternative was institute proceedings in Iran. It can be said that these cases laid a precedent in international standby credits and letters of guarantee practice. The notice injunction will probably be used in future if similar extraordinary circumstances exist. Such circumstances would occur when there is a likelihood of a demand for payment on the letter of guarantee/standby credit


\textsuperscript{380} Ibid.

\textsuperscript{381} In reality, the demand for payment was to be made by Iranian which had issued standby letter credits to the Iranian agencies. Cases where the "notice" injunction was granted included Harris Int. Telecommunications, Inc. v. Bank Melli Iran No. 79-80 (S.D. N.Y. 1979), Stomberg-Carlson v. Bank Melli Iran 467 F.2d 530 (S.D. N.Y. 1979); Becker J., supra, at p.346; Mclaughlin G., "Standby Letters of Credit and Guaranties: An Exercise in Cartography"[1993] 34 William and Mary Law Review 1139 at p.1151.
in an atmosphere where it is difficult to verify the one who made the demand or the one who will receive payment, and also where a fraudulent demand is anticipated and there is no apparent reason to expect that the applicant will get a legal remedy against the beneficiary. These circumstances would appear to be narrow; indeed it would require both political turmoil in the beneficiary's country and "open hostility" against the applicant, as in the Iran-U.S. cases.

Neither the ICC rules nor the UCC address the point of enjoining the beneficiary of a letter of guarantee. If the letter of guarantee is subject to the URDG the bank is required to act according to three different stages when it receives a demand from the beneficiary. Firstly, it is required to examine the demand within "reasonable time" in order to decide whether to pay or not. Secondly, it is required to notify the beneficiary "immediately" about its decision to refuse to pay.382 Thirdly, the bank is required to inform the account party about the beneficiary's demand under the letter of guarantee "without delay".383 All these three types of reactions by the bank indicate the importance of the bank's duty to inform the account party of the beneficiary's demand so as to give him the opportunity to apply for an injunction, whenever suitable, so as to restrain the bank from payment. It is believed therefore that injunctions by the courts would be an ineffective means of preventing a fraudulent demand if there were no obligation upon the banks to inform their customers about the demand before payment.384

382 Art. 10(a) of the URDG reads as follows: "A Guarantor shall have reasonable time in which to examine a demand under a Guarantee and to decide whether to pay or to refuse the demand. (b) If the Guarantor decides to refuse a demand, he shall immediately give notice thereof to the Beneficiary by teletransmission or, if that is not possible, by other expeditious means. Any documents presented under the Guarantee shall be held at the disposal of the Beneficiary".

383 Art. 17 of the URDG.

In practice, however, the bank is not obliged to notify its customer about the beneficiary's demand. Banks believe that such a requirement undermines the letters of guarantee as being cash in hand and will let them become involved in the parties' disputes. Nevertheless, it is submitted that the bank's prompt notification to its customer of the beneficiary's demand could sometimes be vital. The sooner the account party is notified the better. Early notification will give the account party the opportunity to ask for an injunction to restrain the bank from paying the beneficiary's fraudulent demand. To put an obligation on the bank to notify its customer, where it is not subject to the URDG, requires an explicit term to this effect to be inserted in the letter of guarantee application. It is suggested that such duty of notification to the account party should not be misused by him in order to delay payment to the beneficiary. The bank therefore should proceed to payment after a reasonable time, not exceeding three working days from the date of notification, if the account party fails to adduce sufficient evidence of the beneficiary's fraudulent demand. Otherwise, the function of the letter of guarantee as a reliable instrument in international trade will be undermined.

The Uncitral Convention recognises and regulates injunctions against payment in case of independent letters of guarantee and standby letters of credit. It allocates Chapter (5) to deal with the provisional court measures that give the courts the right to issue an injunction against payment if strong evidence is presented to show that the demand by the beneficiary is:

(a) based on false or forged document;
(b) unfairly presented whereas "no payment is due on the basis asserted in the demand and the supporting documents"; or,
(c) made upon an "inconceivable basis" as judged by the "type and purpose of the undertaking". Based on one of these reasons, the court may:
"(a) Issue a provisional order to the effect that the beneficiary does not receive payment, including an order that the guarantor/issuer hold the amount of the undertaking, or
(b) Issue a provisional order to the effect that the proceeds of the undertaking paid to the beneficiary are blocked, taking into account whether in the absence of such an order the principal/applicant would be likely to suffer serious harm.

(2) The court, when issuing a provisional order referred to in paragraph (1) of this article, may require the person applying therefor to furnish such form of security as the court deems appropriate.

(3) The court may not issue a provisional order of the kind referred to in paragraph (1) of this article, based on any objection to payment other than those referred to in subparagraphs (a), (b) and (c) of paragraph (1) of article 19, or use of the undertaking for a criminal purpose”. 385

The article clearly shows that the court has the authority to issue an injunction against (i) the bank to restrain it from payment; or, (ii) the beneficiary to prevent him from demanding on the letter of guarantee. The account party would be required to prove that he would be likely to suffer serious harm or what is alternatively known as "irreparable harm" in the UCC before he would be able to obtain an injunction against payment. The courts may ask the account party to furnish an amount of money as a form of security if his allegations for an injunction appeared to be false or inaccurate.

To be able to obtain an injunction against payment the account party is required to show that he is going to suffer irreparable harm in absence of an injunction.386 Some American courts refused to grant an injunction on the ground that the applicant failed to show actual irreparable harm. The courts

385 Art.19(1) of the Uncitral Convention provides that:
"If it is manifest and clear that:
(a) no payment is due on the basis asserted in the demand and the supporting documents; or
(b) no payment is due on the basis asserted in the demand and the supporting documents; or
(c) judging by the purpose of the undertaking, the demand has no conceivable basis."

refuse to issue an injunction in case of solely alleged threats or remote or speculative irreparable harm.387

The UCC rules do not deal with injunctions against the bank's obligation to pay under the standby letters of credit at all; they only codified the rules relating from Sztejn which was a case of an injunction against a bank. The courts' right to issue injunctions against payment generally stems from section 5-109(b) of the Uniform Commercial Code which reads as follows:

"(b) If an applicant claims that a required document is forged or materially fraudulent or that honor of the presentation would facilitate a material fraud by the beneficiary on the issuer or applicant, a court of competent jurisdiction may temporarily or permanently enjoin the issuer from honoring a presentation or grant similar relief against the issuer or other persons only if the court finds that:
(1) relief not prohibited under the law applicable to an accepted draft or deferred obligation incurred by the issuer;
(2) a beneficiary, issuer, or nominated person who may be adversely affected is adequately protected against loss that it may suffer because the relief is granted;
(3) all the conditions to entitle a person to the relief under the law of this State have been met; and
(4) on the basis of the information submitted to the court, the applicant is more likely than not to succeed under its claim of forgery or material fraud and the person demanding honor does not qualify for protection under subsection (a)(1)."

In English courts, an injunction could be claimed either to enjoin the bank from payment and/or the beneficiary from receiving the amount of money under the letter of guarantee.388 In an allegation of fraud, the issuing bank had to strike a balance between two conflicting interests. If it refused to honour a demand by the beneficiary on its letter of guarantee, it would

387 In KMW International v. Chase Manhattan Bank N.A., supra, at p.15.
388 Goldsmith M.E., supra, at p.152.
jeopardise its reputation in the international financial community. On the other hand, the bank has an interest in protecting its customer's interest, particularly when payment threatens the financial standing of its customer.

The issue on this point is, how can a solution be worked out to address the conflicting equities raised under a letter of guarantee? Indeed, it is difficult to find a solution to accommodate the interests of both the bank and the account party in situations of invalid or fraudulent demands under a letter of guarantee. The difficulty arises from the fact that the structure of a letter of guarantee is clear and straightforward. Its language, in most cases does not warrant two interpretations. It is accordingly submitted that any suggestion as to a solution means a new structure, and a new device. If fraud is alleged by the account party banks normally do not like injunctions to be filed against them so as to save their commercial reputation they encourage their customers to apply for an injunction against the beneficiaries.389 This may raise the question of whether the bank has the right itself to apply for an injunction to restrain the beneficiary from demanding the letter of guarantee if it noticed that the demand might be tainted with fraud. It has been suggested that, since it is the bank's legitimate interest to refuse payment under letters of guarantee whenever it is appropriate to do so, this would also give it the right to file an application for an injunction to stop the beneficiary from demanding the letter of guarantee. There are objections to this view however. Firstly, allowing the banks to seek an injunctive relief would crucially increase their burden to prove fraud and implicate them in the letters of guarantee parties conflict;

secondly that allowing the banks such right would also make some banks adopt this as a routine procedure in order to delay payment without incurring liability to beneficiaries, which could also please certain customers.390

The case of Edward Owen Eng. v. Barclays Bank391 illustrates the application of a high standard of proof when a court decides whether to issue an injunction in respect of a letter of guarantee. It may be recalled that the court in that case decided that the applicant should clearly establish fraud by the beneficiary. In this case, a Libyan employer (beneficiary) had a contractual duty to open an irrevocable letter of credit to pay for services and equipment supplied by an English contractor. The contractor furnished a performance bond to secure his obligation. The Libyan employer failed to open its letter of credit, yet it demanded for payment on the performance bond. Lord Denning denied the injunction seeking to enjoin payment. He equated the performance bond with letters of credit and applied letter of credit law. He held that the performance bond was autonomous and was to be paid.

Prior to Edward Owen, the prevailing rule was that a party who fails to open a letter of credit was in breach of his contract.392 In that event, the party to whom the credit was due was released from his obligation under the contract.393 But this rule was based on commercial letter of credit practice.

390 Fellinger G. A., "Letters of Credit: The Autonomy Principle and the Fraud Exception" [1990] Journal of Banking and Finance Law and Practice, 4 at p.25; See Mclaughlin G., supra, at p.1150 where he says that in the American legal system, "courts, on occasion, have permitted issuing banks to resort to "interpleader" when faced with a payment draw from a beneficiary and an objection to payment from the applicant. Interpleader affords the applicant for the credit the opportunity to present its case against honouring the credit before the proceeds of the credit are over paid to the beneficiary. A "declaratory judgment" action brought by the issuing bank prior to paying its credit has an effect similar to an interpleader action, in that payment to the beneficiary is delayed until the applicant has a hearing on its arguments against paying the beneficiary".


392 e.g., Lindsay (E.A.) & Co. Ltd. v. Cook, [1953] 1 Lloyd's Rep. 328.

393 Ibid., at p.335.
where the opening of the letter of credit also constitutes part performance on the underlying contract. It was neither applied nor explained away by Lord Denning in Edward Owen. If it had been applied, perhaps the decision would have been different. The effect of the case would appear to leave the rule applicable only to commercial letters of credit. As far as letters of guarantee are concerned, they are strictly independent of any assessment on other related contracts.

There is no difference between the English and the Scottish courts in dealing with the issue of injunctions against the banks in the case of letters of guarantee. The courts follow the same policy in avoiding to interference with the banks absolute and independent undertaking under a letter of guarantee.

In the Scottish legal system injunctions against payment are known as "interdicts". The Scottish courts recognised the account parties' rights to obtain an "interdict" whenever fraud is established. Their approach to fraud could be illustrated by the letter of credit case of Centri-Force Engineering Ltd v. Bank of Scotland. In this case a company entered into a contract with suppliers for the supply and installation of pasteurising equipment. According

394 The court would have held that the performance bond was not operative because the English contractors had not received the irrevocable letter of credit from the Libyan employers. There is a possibility that the same result in Edward Owen Engineering Ltd v. Barclays Bank International would have been reached if the court applied the doctrine of separate contracts: that the letter of credit and the underlying transaction are separate. But there are judicial dicta (dissenting opinion), by Everleigh L.J. to the effect that in performance guarantees, the underlying transaction should be relevant in determining performance on the guarantee.

395 The paradox is that the decision in Edward Owen Engineering Ltd v. Barclays Bank International, supra, was premised on the needs of international commerce, yet the application of the then prevailing rule in commercial letters of credit would had a different effect.

396 In Themehelp Ltd v West and Others [1995] 4 All E.R. 215 at p.216 Evans LJ emphasised such requirements by saying that: "The standard of proof required by the bank's customer if it seeks an interlocutory injunction to restrain payment by the bank is high".

to the contract terms and conditions 50% of the purchase price was payable under an irrevocable letter of credit issued by the bank of the company. The letter of credit was payable upon the presentation of, *inter alia*, a certificate signed by engineers to confirm that the equipment was in a satisfactory working condition. A certificate was subsequently issued by the engineers confirming the satisfactory condition of the equipment and appeared on its face to comply with the relevant terms and conditions of the credit. Accordingly the company moved to seek an "interdict" to restrain the bank from payment on the basis that the certificate had been fraudulently issued. The company's application was declined by the court on the grounds that the only defence against the bank's payment was where the request for payment is made fraudulently in circumstances where there is no right to payment and the bank's knowledge of fraud. Lord Abernethy in this case said:

"I am of opinion that there are no averments in the petition which would justify interfering with the honouring of the credit. To put it in the context of the Scots approach to interim interdict the petitioners have not in my opinion established a prima facie case. It follows, therefore, that consideration of the balance of convenience does not arise. I shall accordingly refuse the motion for interim interdict".398

Generally speaking, it seems that in the English jurisdiction the authority to enjoin the beneficiary from receiving payment is based on the general powers of the courts. Two cases illustrates this development. One is the English Court of Appeal case of *Potton Homes Ltd. v. Coleman Contractors (Overseas) Ltd.*399 Potton Homes had given a first demand performance letter of guarantee to Coleman to assure the supply of

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398 Ibid.
prefabricated building units. Dispute arose between the parties. Potton Homes sought and obtained an interim injunction preventing the cashing of the performance letter of guarantee by Coleman. The latter appealed. Allowing the appeal and discharging the injunction, May L.J. based his decision on the similarity between the performance bonds and letters of credit. But Everleigh J. was cautious about applying the rules of letters of credit to performance bonds. He acknowledged that a letter of credit is independent from the underlying transaction, but thought that a different view should be taken of performance letter of guarantee:

"But the underlying contract might still be relevant in determining the parties obligations to one another under the bond... If the [seller] had lawfully avoided the contract or if there was failure of consideration, he should prima facie be entitled to restrain the [buyer] from making use of the bond."400

In brief, Lord Everleigh was of the view that even though a letter of credit is autonomous, a court can enjoin the beneficiary from seeking payment.

The second is the case of Themehelp Ltd v. West and Others401 the court held that an interlocutory injunction can be granted against the beneficiary of the performance bond restraining him from making demand where a prima facie case of fraud is established.402 In this case the plaintiffs

400 Ibid.
401 [1995] 4 All E.R. 215 at 216
402 In England, the right to issue injunctions is based on the Supreme Court Rule 1 Order (29) which reads as follows:
"(1) An application for the grant of an injunction may be made by any party to a cause or matter before or after the trial of the cause or matter, whether or not a claim for the injunction was included in that party's writ, originating summons, counterclaim or third party notice, as the case may be.
(2) Where the applicant is the plaintiff and the case is one of urgency such application may be made ex parte on affidavit but, except as aforesaid, such application must be made by motion or summons.
asked their bank to provide the defendants with a performance bond to secure their obligation in accordance with the underlying contract. The letter of guarantee was payable upon the defendant's notice following the plaintiff's default. The plaintiffs accordingly were required to indemnify the guarantors for any amount of money they may be paid under the letter of guarantee. A dispute between the parties arose in which the defendant's considered the plaintiffs to be in default. The plaintiffs thereupon applied to the court for an interlocutory injunction restraining the defendants from giving notice to the guarantors until trial of the action. The judge at first instance granted the injunction. The defendants appealed the decision on the basis that granting an injunction was wrong because it contradicted the principle of autonomy in performance letters of guarantee which made the injunction, in their view, unnecessary and/or an excessive form of relief. Their appeal, however, was dismissed on the ground that independently of the right of the guarantor to refuse payment on the ground of fraud, a performing party may apply for an injunction to restrain enforcement of a performance guarantee by the beneficiary if he can prove fraud on the part of the beneficiary of which the guarantor has knowledge.

Two points of view were adopted by the judges in this case on the issue of whether to grant injunction relief which prevents the bank from payment under the letter of guarantee. The first point of view was expressed by Evans LJ who believed that granting an injunction would be harmful to the integrity of the banking system and to the standards of commercial morality.

(3) The plaintiff may not make such an application before the issue of the writ or originating summons by which the cause or matter is to be begun except where the case is one of urgency, and in that case the injunction applied for may be granted on terms providing for the issue of the writ or summons and such other terms, if any, as the Court thinks fit": Jacob J. The Supreme Court Practice (1990) at p.497
which the courts should uphold.\textsuperscript{403} The learned judge concluded that granting an injunction against payment in this case is unjustified "both generally as a matter of principle and in the circumstances of this particular case".\textsuperscript{404} Both Waite L.J and Balcombe L.J., on the other hand, had taken a different view by supporting the court's right to grant an interlocutory injunction.\textsuperscript{405} Balcombe L.J said:

"In such a case I see no reason why the ordinary principles for the grant of interlocutory injunctive relief should not apply"\textsuperscript{406}

He was also reluctant to grant a Mareva injunction, i.e. an order made to freeze the money paid under the performance letter of guarantee in the hands of the defendants on the ground that this would force the plaintiffs to indemnify the guarantor "so that the real issue before the court then becomes which of the two parties should be out of pocket pending the trial: the defendant vendors against whom a strongly arguable case of fraud has been presented, or the plaintiff buyers? I do not accept that the powers of the court are so limited as to be unable to grant the form of interlocutory relief that the justice of the case requires"\textsuperscript{407}

The reasoning in Potton Homes v. Coleman and Themehelp Ltd. v. West and Others as set out above is at variance with the decision of Lord Denning in Edward Owen. For one thing, Potton Homes undermines the

\textsuperscript{403} Supra. at p.230.

\textsuperscript{404} Ibid.

\textsuperscript{405} Ibid at p.233.

\textsuperscript{406} Ibid at p.234.

\textsuperscript{407} Ibid at p.235.
assurance of payment guaranteed by the autonomy principle when it permits the beneficiary to be enjoined. Secondly, the decision would allow an injunction which is not based on the law of letters of guarantee. As such, the high standard of proof required in letters of guarantee before an injunction is issued is not applied. The decision would also reallocate, among the parties, the risk of litigating without funds which is a major reason for choosing the letter of guarantee instrument. As such, decisions following this trend have been criticised as not being supported by precedent or policy.

It may be stated that the availability of injunctive relief against the beneficiary circumventing Edward Owen is regrettable if its effect is to weaken the assurance of payment under the letter of guarantee and the safeguards that have developed over time to prevent abuse of letters of guarantee. Yet it appears not possible, or at least inadvisable, to legislate against such injunctions that derive from the inherent power of the courts.

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408 Pierce A., supra, at pp.187-90.; see also Fellinger G. A., "Letters of Credit: The Autonomy Principle and the Fraud Exception", 1990 Journal of Banking and Finance Law and Practice, 4 at p.18. R.D. Harbottle (Mercantile) Ltd v. National Westminster Bank Ltd. [1977] 2 All E.R. 862 at p.872 (Q.B) The House of Lords has refused to lay down rigid rules because interlocutory injunctions are an equitable remedy and should remain flexible. However, in American Cyanamid Co. v. Ethicon Ltd. [1975] 1 All E.R. 504, the Law Lords did set out a number of guiding principles: (i) consider whether there is a serious question to be tried (in sense of not being frivolous or vexatious); (ii) consider whether the balance of convenience lies in favour of granting or refusing interlocutory relief-(a) if damages at trial would not adequately compensate the plaintiff and would adequately compensate the defendant, then there are no grounds for refusal. -(b) if neither is compensable in damages then go on to consider specific factors in determining where the balance of convenience lies; and (iii) where the parties incompensable injuries are equal the best approach is to preserve the status quo. Where the practical effect of the preliminary application is to finally determine the matter at issue, then the likelihood of success at trial becomes a factor to be put into the balance when weighing the risks; N.W.L. Ltd v. Woods [1979] 3 All E.R. 614 at 626 (H.L).

409 Dolan J.F., supra, at para.7.51.

410 The URDG would not contain such a prohibition, as it primarily concerns itself with operational rules for letters of guarantee. Under the UCC and all other cases, there appears to be no defensible legal doctrine on which to base a rule prohibiting the injunction.
is submitted that the solution to this problem will lie in the courts' approach towards the issue. While the courts may entertain applications by account parties for injunctions against beneficiaries, it is submitted that they should require applicants to meet the same degree of proof of fraud as if the injunctions are sought against the banks. If proof of fraud is no longer required or if the standard of proof is relaxed, as suggested by Potton Homes, the usefulness of the injunction will have been extended beyond safe limits. It is not suggested that the availability of injunction should be quite as limited as in the "clear fraud" test in Edward Owen. The argument is that expanding its scope too much spoils the attraction of the letter of guarantee. It is therefore suggested that if an injunction is sought against a beneficiary, the court hearing the case should apply the current standard of injunctive relief but that it should apply it to the underlying transaction. Some U.S. cases have already been decided on these lines. For example, the court in Jupiter Orrington Corporation v. Zweifel\(^\text{411}\) decided that an injunction against the beneficiary can only be granted on the basis of fraud which vitiates the whole transaction. It further held that such fraud must relate to the formation of the underlying contract and not to the performance of the contract. The court well recognised the necessity of refusing an injunction against the beneficiary if no injunction would be issued against the bank under s.5-109(b) of the UCC. This case gives guidance on the standard and "location" of fraud that justify an injunction against the beneficiary, and reaffirms the principle that disputes concerning performance of the underlying contract cannot be the basis of injunctive relief. It is submitted that this decision strikes a good balance between the legal right to enjoin the beneficiary from demanding payment.

\(^{411}\) 469 NE 2d.509 (1984).
under a letter of guarantee/standby letter of credit, and the policy of protecting letters of guarantee as reliable commercial instruments.
CHAPTER FIVE

THE AMBIT OF A BANK’S DUTIES AND RESPONSIBILITIES UNDER THE LETTERS OF GUARANTEE.

5.1 General

Once it issues a letter of guarantee, a bank has certain duties and responsibilities.412 One of its significant duties is to pay the proper beneficiary under the letter of guarantee. A bank, therefore, cannot be discharged from liability nor ask for reimbursement unless this duty has been properly carried out.

The proper performance of a bank’s duties under the letter of guarantee is not confined to the proper performance of the duties and responsibilities of its own but requires also the observation of the proper performance of its instructions by its correspondent. Under an indirect letter of guarantee, the instructing bank recognises that using the services of the correspondent bank could lead the instructing bank into serious difficulties with consequential liability. To avoid such difficulties the instructing bank in practice relies on certain clauses that aim to limit its liabilities and responsibilities under the letter of guarantee.

A bank’s limitation of liability under a letter of guarantee may raise some intricate legal issues as to the nature of these exemption clauses as used by banks413 and the legal grounds on which the account party could rely to remedy any delicate situation that might arise from the exemption clauses.

The task of this chapter is to deal, inter alia, with these topics.

412 Most of these duties and responsibilities were discussed in chapters 2 & 3.


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5.2 The Duty To Pay The Proper Beneficiary.

A bank may pay intending to discharge its obligation under the letter of guarantee. But the payment made may be disputed on the grounds that it has not been made to the proper beneficiary. It is of the utmost importance, therefore, that the bank's payment be made to the proper beneficiary. Payment to a different party does not discharge the obligation under the letter of guarantee. The possibility of paying a wrong party is increased because letters of guarantee secure obligations that usually extend over long periods of time. During this time, the names of designated beneficiaries may change. While this is not illegal or unusual, it may cause problems if an account party for a particular letter of guarantee contests the new entity as being the proper beneficiary.\footnote{It is of utmost importance, therefore, that the bank's payment be made to the proper beneficiary. Payment to a different party does not discharge the obligation under the letter of guarantee. The possibility of paying a wrong party is increased because letters of guarantee secure obligations that usually extend over long periods of time. During this time, the names of designated beneficiaries may change. While this is not illegal or unusual, it may cause problems if an account party for a particular letter of guarantee contests the new entity as being the proper beneficiary.} This issue is illustrated in American Bell Inc. v. Manufacturers Hanover Trust Co.,\footnote{414 474 F.Supp 420 (S.D.N.Y 1979)} a case on standby letters of credit. The case arose out of a successful revolution in Iran, something that is not a remote possibility in developing countries. The letter of guarantee had been opened by the bank, Iranshar, in Iran and counter-guaranteed by a standby letter of credit issued by Manufacturers Hanover Trust in the U.S. The beneficiary of the letter of guarantee in Iran was the "Imperial Government of Iran Ministry of War." After the 1979 revolution, a demand for payment on the same letter of guarantee was made by "The Government of Iran Ministry of Defence, successor to the Imperial Government Ministry of War." It was honoured by the Iranshar Bank. Before this bank claimed on the standby letter of credit issued by Manufacturers Hanover, the applicant sought a preliminary injunction in the U.S seeking to enjoin Manufacturers Hanover from paying.

414 The bank becomes more concerned if it would be difficult to recover from the "beneficiary" once payment is made.

415 474 F.Supp 420 (S.D.N.Y 1979)
The injunction was denied.\textsuperscript{416} Later the Iranshar Bank made a claim for payment.\textsuperscript{417} Though the case turned on the grounds for obtaining an injunction, the court also discussed the issue of a different beneficiary under the standby credit in Iran. This was treated as a matter of international law. The court reasoned that since the United States government recognised the Islamic Government of Iran as successor to the Imperial Government, its recognition was binding on the courts.\textsuperscript{418} A necessary consequence was that contract rights of the old government, including these arising from letters of guarantee, vested in the new government.\textsuperscript{419} An important aspect of the American Bell decision was the application of the international law to the exclusion of the normal law on letters of guarantee law.\textsuperscript{420} The case introduced some flexibility into the law on letters of guarantee by allowing banks to pay successor entities of beneficiaries. The decision on who is a proper successor, of course, extends beyond the administrative function of the bank; but it can be undertaken if proper means of proof which are easily verifiable are available.\textsuperscript{421} This flexibility however, is not without its difficulties for banks. It requires them to make decisions on payment by considering beyond letter of guarantee law, like state succession.

\textsuperscript{416} Ibid.

\textsuperscript{417} At first non-confirming documents were tendered, but the defect was remedied in time. Ibid, at p.422.

\textsuperscript{418} Ibid at p. 423.

\textsuperscript{419} Ibid.

\textsuperscript{420} Further since the letter of guarantee was not transferable (see URDG Art. 4, UCP Art.48, UCC Art. 5-112) no party other than the original beneficiary could tender documents to claim under the letter of guarantee.


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Obviously, issues of succession are not limited to sovereign entities and international law. They involve other areas like corporation and partnership law. In such cases, would it be proper to pay a new entity whose name does not strictly comply with that in the letter of guarantee? If, however, the bank is not satisfied that the entity demanding payment is legally the successor of the beneficiary, the safer action would be defer payment and seek court direction.

It seems that the difficulties arising from the bank's task of deciding who is the proper beneficiary under the standby letter of credit in cases like *American Bell* had led to the existence of Section 5-113 of the UCC which recognises the successor's right to draw under the standby letters of credit. The UCC defines the successor as a person who "succeeds to substantially all of the rights of a beneficiary by operation of law."422 The successor completely replaces the beneficiary under the standby letter of credit. He has the right to sign and present documents or demands and to receive payment in the name of the beneficiary. He also has the right, for example, to consent to proposed amendments by the bank or the account party by extending the expiry date or to any proposed changes in the stated amount in the amount of standby letter of credit.

The same article gives the successor the right either not to disclose his status and to be paid in the beneficiary's name or to disclose his status in order to be paid in his own name.423 In the latter case the bank would assume

422 Art. 5-102(a)(15)

423 Section 5-113 of the UCC provides:

"(a) A successor of a beneficiary may consent to amendments, sign and present documents, and receive payment or other items of value in the name of the beneficiary without disclosing its status as a successor.

(b) A successor of a beneficiary may consent to amendments, sign and present documents, and receive payment or other items of value in the name of the beneficiary without disclosing its status as a successor."
no responsibility for determining whether the purported successor was the beneficiary's successor or not.424 The bank, accordingly, is entitled to be reimbursed immediately by the account party or the instructing bank, as the case may be, if it pays in accordance with the documents which appear on their face to be in accordance with the terms and conditions of the standby letter of credit.425 This will no doubt help the bank to reduce the risks of taking some difficult decisions such as whether the person who is presenting the demand is the proper beneficiary or not.

5.3 The Effect Of The Employment Of Agents On The Bank's Obligation To Pay.

The employment of agents in letters of guarantee and standby letters of credit transactions may lead to allegations that payment has been demanded by or made to wrong party. A case in point is Dynamics Corporation of America v. Citizens & Southern National Bank.426 The standby letter of credit in this case secured a contract for delivery of equipment to India. The beneficiary whose signature was required to trigger payment on the standby letter of credit was designated as "The President of India." The certificate tendered to the bank on demand for payment was signed on behalf of the President. Dynamic Corporation sought to enjoin payment of the credit on the

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424 Section 5-113 of the UCC provides: "(c) An issuer is not obliged to determine whether a purported successor is a successor of a beneficiary or whether the signature of a purported successor is genuine or authorized".

425 See Section 5-108(i) of the UCC.

basis of non-compliance with the credit terms.\textsuperscript{427} While the decision of this case turned on other points.\textsuperscript{428} India contended that it was simply ridiculous to assume that the certificate had to be signed by the President of India himself.\textsuperscript{429} It submitted that under its constitution, the Joint Secretary to the Government could sign on behalf of the President.\textsuperscript{430} The wording of the decision indicates that India's argument prevailed. Taken as a precedent, the decision allows agents to sign on behalf of their principals\textsuperscript{431} even when this fact is not specifically addressed in the standby letter of credit. There is a danger with this for banking practice. The business of banks would become clogged if on occasions unspecified agents signed and presented documents. Banks would have to rummage through the beneficiaries Constitutions, Memoranda of Association and Minutes of board meetings trying to ascertain who the agents were, in what circumstances they might sign for their principals, and indeed, whether the documents being read were the current and authentic versions.\textsuperscript{432} It is therefore, submitted that the practice of allowing agents to sign should be strictly limited. Perhaps, in this connection, the decision in \textit{Dynamics Corporation} allowing the bank to pay a standby

\textsuperscript{427} The real argument was that India's demand on the standby letter of credit was fraudulent. Non-compliance with the credit terms was a ground raised in support of this argument, see ibid. at pp.991-2.

\textsuperscript{428} The case turned on issues of the law applicable to the standby letter of credit and fraud, see ibid. at p. 992.

\textsuperscript{429} Ibid. at 997.

\textsuperscript{430} Ibid.

\textsuperscript{431} This case would allow agent to sign on behalf of the President.

\textsuperscript{432} A bank's mistake on this last point would likely not be excused under Articles 18 of the UCP, 5-108 & 5-109 of the UCC and Article 11 of the URDG. In general, under these Articles the bank is not exempted from liability for any falsified or inaccurate documents which may be tendered in support of a demand for payment.
letter of credit against non-complying documents should be viewed in the light of the precedence of public law over letter of guarantee and stand by letter of credit law, and not be taken to set a precedent for normal banking practice. In the absence of overriding policy reasons such as existed in *Dynamics Corporation*, the practice of allowing agents to sign should be limited to those agents who are named in the standby letter of credit or guarantee and any amendments thereto, and are specifically authorised to demand payment. The case of *Cleveland Manufacturing Co. Ltd v. Muslim Commercial Bank* stands as authority for the view that a bank must pay twice over if it has paid the wrong party. *Cleveland v. Muslim Commercial Bank* was a commercial letter of credit case. The plaintiff (beneficiary-seller) asked its agent, a shipping company, to ship goods and prepare the documents for presentation under a letter of credit. After the goods were shipped, an employee of the shipping company prepared the shipping documents. He also prepared and signed a sight draft. The draft was typed and signed on the plaintiff's behalf on letterheads supplied by the plaintiff. These documents were later tendered to the bank by the agent. The bank paid the agent who, due to subsequent insolvency, failed to pay the plaintiff. The plaintiff claimed payment from the bank, arguing that the bank had paid the wrong party. The decision in the case turned on the law of agency. The court decided in favour of the plaintiff. It reasoned that since the agent employed was a shipping agent, there was no apparent authority for one of its employees to endorse the draft in blank. The court argued that the authority of an agent who is

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433 The decision of *American Bell,* supra, could also be explained on this basis.


435 It also illustrates the problems caused by agents in letter of credit practice, see also ibid., at 648-9.
normally a shipper does not extend to the preparations of drafts.\textsuperscript{436} So the bank was required to pay the proper beneficiary of the letter of credit.

To avoid circumstances in which the bank might be held liable for wrongful payment based on unauthorised signature banks under the revised Article 5 of the UCC Section 5-113(c) have been exempted from the obligation to determine whether the purported successor of a beneficiary is in reality his successor or whether the signature of a purported successor is genuine or authorised. The word "purported" is used to make clear that the bank is under no duty to verify the genuineness of a presentation document's signature or the authority of a signatory. This sounds reasonable as the standby letter of credit may require that presentation copies of documents be prepared by someone other than the beneficiary as evidence of the beneficiary having met his obligations pursuant to the underlying contract with the account party.\textsuperscript{437}

5.4 A Bank's Limitation Of Liabilities.

In practice, beneficiaries commonly stipulate for the issuing of a letter of guarantee by a bank in their own country as this, in their view, has many advantages.\textsuperscript{438} In this case, the account party requests his bank to instruct a

\textsuperscript{436} Ibid, at 650.

\textsuperscript{437} Wunnicke B. & D. and Turner P., Standby and Commercial Letters of Credit (2nd ed. 1996) at p.359.

\textsuperscript{438} See Bertrams R., Bank Guarantees in International Trade (2nd ed. 1996) at p.65 says "An indirect letter of guarantee is advantageous to the beneficiary on several counts. The primary letter of guarantee will be by local law and practice and this particularly important with respect to the validity period of the letter of guarantee. The risk of currency exchange restrictions is also eliminated. The issuing bank could be the house bank of the beneficiary and, if not, he is at least in a better position to assess its reliability and financial standing. Contacts with the bank run more smoothly and any possible problems could resolved more easily than would be the case with a foreign bank".
correspondent bank, ordinarily located in the beneficiary's country, to issue a letter of guarantee in accordance with its terms and conditions.

The involvement of the issuing bank can sometimes result in mistakes which can seriously affect the account party's position under the letter of guarantee. Such mistakes might lead, for example, to an enormous financial loss suffered by the account party as a result of the correspondent's delay in notifying the letter of guarantee to the beneficiary.439 In principle, no legal problem seems to face the account party in turning to his own bank to claim any damages he might sustain as a result of the correspondent bank's acts or omissions. The issue, however, might not be as simple as it seems. In practice, banks are usually very keen to insert a number of exemption clauses in their agreements with the customers, by which they exempt themselves from different kinds of liabilities. The common use of exemption clauses has raised some legal issues such as the legal grounds for the insertion of such clause and the extent to which banks can rely on these clauses to be exempt from liability.

To review the nature of the exemption clauses that are commonly used in a letter of guarantee transaction it might be useful to give as examples some of the clauses which have been provided by the ICC rules and the Uncitral convention. Unlike the URDG, Art.3 of the URCG does not provide banks with a variety of exemption clauses. The article sets forth a general limitation of liability according to which a bank is to be only liable in accordance with the terms and conditions specified in the letter of guarantee.440 On the other

439 See, for example, Ozalid (Group Export) Ltd. v. African Continental Bank Ltd. [1979] 2 Lloyd's Rep. 231. A case concerning a letter of credit where a bank based in Africa and operating in Europe was required to pay in American dollars. Normally the bank relied on Chase Manhattan in U.S.A for the supply of dollars. On this particular occasion, Chase Manhattan did not produce the dollars promptly enough, thereby making the defendant bank default on its commitment to pay.
hand, the URDG contains a number of articles which absolve the bank from many sorts of liabilities. Articles 11-14 of the URDG demonstrate a good example of the sort of exemption clauses that are commonly used by banks in international letters of guarantee. Art. 11 of the URDG should be considered as the starting point for any bank which wishes exemption from liability under the letter of guarantee. A bank, according to this article, could limit its liability or responsibility for the form, sufficiency, accuracy, genuineness, falsification, or legal effect of any document when presented to it as a condition for payment.441 A bank would be accordingly exempted from liability if it pays on a conditional letter of guarantee supported, for example, by a forged certificate issued by a surveyor testifying that the project has been adequately completed, or if it proceeds to payment with regard to a certificate presented by the beneficiary certifying that the account party is in default which turns out to be forged later on. In this case, the bank could limit its responsibilities to the extent of exercising a reasonable care in examining the documents that are presented to it by the beneficiary under the letter of guarantee. This means that the bank has only to show that it has done its duty by ascertaining if the documents appear on their face to conform to the letter of guarantee terms and conditions and to be consistent with one another.442 If it fails to perform any of these duties properly it should be denied reimbursement from the account party under the letter of guarantee.443

440 Art. 3(1) of the URCG.

441 Article 11 provides "Guarantors and Instructing Parties assume no liability or responsibility for the form, sufficiency, accuracy, genuineness, falsification, or legal effect of any document presented to them or for the general and/or particular statements made therein, nor for the good faith or acts or omissions of any person whomsoever."

442 See Art. 9 of the URDG.

The limitation of a bank's liability under the rules also includes the limitation against communication and translation errors. There is no doubt that in recent years, innovations in electronic communication have dramatically affected the transmission of information and of money. These changes have substantially facilitated letter of guarantee and money transfer operations. The term "telecommunication" encompasses recent and anticipates future developments in electronic communication and electronic banking transactions. Telecommunication can include many types of electronic banking transactions and interbank data transmission through automated funds clearing systems and domestic and international wire transfer systems. Many banks that are active in the letters of guarantee market have been installing an automated letter of guarantee service. Banking business has become, more than ever before, very dependent on the use of all sorts of communications. The extensive use by banks of such methods of communication holds significant risks of being held responsible for technical errors. A bank could avoid such undesirable consequences by relying on Art. 12 of the URDG. According to this article, a bank could be absolved from liability for the "consequences that could arise out of delay and/or in transit of any messages, letters, demands or documents, or for delay, mutilation or other errors arising in the transmission of any telecommunication". A bank accordingly, could be absolved from liability for a delay in its instructions to the correspondent bank to issue a letter of guarantee if the cause of this error appears to be a technical defect in its transmission system. For example, if because of a defect in the bank's transmission system the amount of the letter of guarantee was misstated as being US$101,000 instead of US$110,000 or the expiry date was given as being 21.1.1997 instead of 2.1.1997. The same article also absolves the bank from any error in translation or interpretation of technical terms and
allows the bank to reserve the right to transmit letters of guarantee texts or any parts thereof without translating them.\textsuperscript{444} It seems that absolving the bank from liability could be justified in international banking business on the ground that it would be unfair to hold the bank liable for languages of which it lacks the knowledge.\textsuperscript{445} Therefore, it has become a common practice for banks to reserve the right to transmit the text of the letter of guarantee and/or any related documents without translation in order to avoid the consequences of poor translation. Exempting the bank from errors arising in the transmission of any telecommunication should not be interpreted as a limitation of the bank's liability from its own negligence. The bank, therefore, should be barred from relying on this article where it can be proved that it failed to take the necessary precautions by making a regular check on its transmission system. The bank, for example, should always make sure that its fax machine is loaded with paper all the time.

The international nature of letters of guarantee most of the time requires the involvement of a foreign correspondent bank to issue the letter of guarantee for the beneficiary in its own country. Utilising the services of a foreign bank has its own risks. The foreign bank, for example, might commit mistakes such as paying the letter of guarantee beyond its date of expiry which would definitely lay some financial risks on the instructing bank's

\textsuperscript{444} Article 12 of the URDG provides that: "Guarantors and Instructing Parties assume no liability or responsibility for the consequences arising out of delay and/or loss in transit of any messages, letters, demands or documents, or for delay, mutilation or other errors arising in the transmission of any telecommunication. Guarantors and Instructing Parties assume no liability for errors in translation or interpretation of technical terms and reserve the right to transmit Guarantee text or any parts thereof without translating them".

\textsuperscript{445} In practice, however, translation does not seem to be a problem for the parties, because most of the letters of guarantee and related documents are drafted in English language which is internationally recognised: Goode R., Guide to the ICC Uniform Rules for Demand Guarantees, (1992) at p.75.
shoulders. The instructing bank therefore should endeavour to avoid such consequences by absolving itself from the liability for the acts and omissions of the correspondent bank.\textsuperscript{446} According to Art. 14(b) of the URDG the instructing bank is able to absolve itself from liability for non-performance of its instructions by the correspondent bank even if it was the instructing bank itself which took the initiative in choosing the correspondent.\textsuperscript{447} This would simply mean that the expense and the risk of using the correspondent's services are to be placed on the account party's shoulders. Again, it should be emphasised that this article should not be interpreted as exempting the instructing bank from the liability for its own negligence. The bank must be under the duty to exercise good faith and reasonable care in the selection of a competent and properly functioning correspondent.\textsuperscript{448} Apparently, the bank cannot be exempted from responsibility if it appears that it has selected an inefficient correspondent.\textsuperscript{449} It has been submitted, therefore, that the instructing bank which has some reason to believe that its correspondent will not be able or willing to execute its instructions within the time required remains responsible for the correspondent's failure to do so, except where the account party with the knowledge of the situation, has approved the choice of the correspondent.\textsuperscript{450} The instructing bank could justify its decision in

\textsuperscript{446} Art. 14 (a) of the URDG provides that "Guarantors and Instructing Parties utilising the services of another party for the purpose of giving effect to the instructions of a Principal do so for the account and at the risk of that Principal".

\textsuperscript{447} Art. 14 (b) of the URDG "Guarantors and Instructing Parties assume no liability or responsibility should the instructions they transmit not be carried out even if they have themselves taken the initiative in the choice of such other party."

\textsuperscript{448} Bertrams R., supra. at p. 134.

\textsuperscript{449} The only other possibility would be for the account party to show that his bank, i.e., the instructing bank, was in breach of contract or negligent in its choice of correspondent. However, it is almost impossible for the account party to prove such claim.
selecting the correspondent bank by showing a good previous course of commercial dealing. Otherwise, it is probable that the instructing bank would be prevented from relying on the exemption from its liability for the foreign bank's acts and omissions.

Absolving the instructing bank from liability for the acts and omissions of the foreign banks would indeed entail the same exemption from all obligations and responsibilities imposed by foreign laws and usages.\textsuperscript{451} The terms "foreign laws or usages" seem to be used in this text to refer to the law and usages of a country other than the one in which the bank has its place of business or from which the letter of guarantee or the counter letter of guarantee is issued; the bank should be familiar with the laws and usages of its own country. The application of this article would mean, for example, that the bank could be absolved from liability that would have been resulted from payment of the letter of guarantee beyond its expiry date under a foreign law which does not recognise an expiry date of the letter of guarantee.

The tendency of the banks in international business transactions, including the letter of guarantee, seems to be towards the insertion of clauses similar to those already mentioned under which the bank feels secure from any unexpected risk. The same attitude appears more clearly in the exemption clauses according to which banks limit their liabilities and responsibilities against the interruption of their business by the reason of "acts of God, riots, civil commotions, insurrections, wars, strikes, lock-outs and industrial actions of whatever nature".\textsuperscript{452} By relying on this article, the bank makes it clear that

\textsuperscript{450} Goode R., Guide to the ICC Uniform Rules for Demand Guarantees, (1992) at p.79.

\textsuperscript{451} Art. 14 (c) of the URDG provides that: "The Principal shall be liable to indemnify the Guarantor or the Instructing Party, as the case may be, against all obligations and responsibilities imposed by foreign laws and usages."
its liability ends when its business is interrupted for one of the above mentioned reasons. The most common of such clauses is the limitation of liability as a result of force majeure. The application of this article could raise some questions as to what the bank's liability would be if it was forced to close due to the occurrence of force majeure where on the resumption of its business the letter of guarantee was found to have expired. Under similar circumstances the application of Article 14(c) would leave the beneficiary without any compensation against the loss he might incur as a result of the account party's default. To bridge this gap, one might suggest that the insertion of a clause which states that if the letter of guarantee expires while the bank is closed under conditions of force majeure, the expiration date of the letter of guarantee is extended for some period (such as 30 days) after the bank reopens. Finally, it seems that this article goes too far by absolving banks from liability for any other causes "beyond their control". Thus, the application of this article would give the bank the chance to escape all sorts of responsibilities; even a strike by its own employees could be considered as a cause "beyond its control". This might lead eventually to a careless attitude to the execution of the bank's duties under the letter of guarantee.

A bank's limitation of liability also includes the limitation of the amount of money the bank is obliged to pay under the letter of guarantee. When it receives a demand from the beneficiary under the letter of guarantee, the bank should make sure that it does not exceed the amount stated therein

452 Art. 13 of the URDG provides that "Guarantors and Instructing Parties assume no liability or responsibility for consequences arising out of the interruption of their business by acts of God, riots, civil commotions, insurrections, wars or any other causes beyond their control or by strikes, lockouts or industrial actions of whatever nature".


454 See Art. 3(1) of the URCG.
regardless of the loss actually suffered by the beneficiary as the result of account party's breach. This point has been illustrated in *Cargill International S.A. Antigua Geneva Branch And Another v. Bangladesh Sugar & Food Industries Corporation* case. In this case, the plaintiff (Cargill) and the defendant (Bangladesh Sugar) had entered in a contract whereby Cargill agreed to sell the defendant 12,500 tonnes of sugar. The plaintiffs were required to provide the plaintiff with performance bond covering 10% of the total value of the sale contract. There was an express promise by the plaintiffs to ensure the arrival of the cargo at a designated port before the 15th of Sept.1994 and there was a stipulation in the contract that the cargo would be trans-shipped in a vessel which was no more than 20 years old. At a later stage, the performance bond was called in by the defendants on the grounds that plaintiffs had failed to deliver the cargo on time and had shipped it in a vessel more than 20 years old. The plaintiffs contended that defendants have suffered no loss from any alleged breach in that the sugar market had fallen so that when the buyer rejected the goods they were able to replace them with sugar at a lower price than they contracted to pay.

One of the issues raised in the case was whether the defendants(beneficiaries) were entitled to make a call for the full amount of the performance bond, if the breach or breaches of contract caused some loss to the defendant which was equal to or greater than the amount of the performance bond. In this case it was decided by Morison J. "The bond is not intended to represent an "estimate" of the amount of damages to which the

455 Article 16 of the URDG provides that: "A Guarantor is liable to the Beneficiary only in accordance with the terms specified in the Guarantee and any amendment(s) thereto and in these Rules, and up to an amount not exceeding that stated in the Guarantee and any amendment(s) thereto".

beneficiary may be entitled for the breach alleged to give rise to the right to call. The bond is a "guarantee" of due performance. If the amount of the bond is not sufficient to satisfy the beneficiary's claim for damages, he can bring proceedings for his loss."\(^{457}\) The learned judge continues "As far as I am aware, and no case was cited to me to suggest otherwise, the performance bond is not intended to supplant the right to sue for damages. Indeed, such a contention would conflict with what I believe to be the commercial purpose of these instruments."\(^{458}\) The learned judge also concluded that there is no room for a claim by the beneficiary for damages which exceeded the stated amount of the letter of guarantee. The learned judge rejected the beneficiary's contention in this regard for being "without legal foundation and as lacking in commercial good sense."\(^{459}\)

The learned judge's conclusion emphasises the legal nature of the bank's obligation to pay under the letters of guarantee as being an independent undertaking to pay the amount of the letter of guarantee regardless of the amount of damages suffered by the beneficiary. This issue and other issues like the true amount of damages sustained by the beneficiary as a result of the account party's default must be beyond the bank's concerns. Any conduct by the bank to the contrary would be interpreted as an interference by the bank in the underlying relationship of the parties and would also conflict with the commercial purpose of these instruments. The bank, therefore, should avoid being involved in the parties' conflicts. It should pay, as long as it receives a

\(^{457}\)Ibid. at p.528

\(^{458}\) Ibid.

\(^{459}\) Ibid at p.528-9.
demand which conforms to the terms and the conditions of the letter of guarantee.

The ambit of the bank's obligation to pay under a letter of guarantee could also raise the question of whether a beneficiary under a letter of guarantee owes the bank a duty to mitigate its damages and, regardless of the existence of any such duty, whether any actual mitigation entitles the bank to a corresponding reduction of the beneficiary's recovery under the letter of guarantee. This question has been recently raised in a standby letter of credit case. In *San Diego Gas & Electric Company v. Bank Leumi* \(^{460}\) the Leumi Bank (the "bank") issued a standby letter of credit in the amount of US$ 425,000 for the benefit of San Diego Gas & Electric Company ("SDG&E") securing the performance of one of SDG&E's electricity suppliers ("Luz"). SDG&E was entitled to receive payment under the standby letter of credit upon presenting a draft on the bank and statement, signed by an authorized representative of SDG&E, certifying (i) that the drawing was made in accordance with the underlying contract between SDG & E and Luz (the "Contract"), and (ii) listing Luz's deficiencies in performance. SDG&E made a conforming demand for the entire amount under the letter of credit, which the bank dishonoured. SDG&E sued to compel payment, and the lower court granted SDG&E summary judgment on the issue.

The bank appealed the court's decision. The points at issue in the appeal were the bank's contentions that: (i) SDG&E had a duty to the bank, and could, in fact, mitigate its damages after Luz breached the Contract, and (ii) the bank was entitled to reduce its payment under the standby letter of credit to the extent SDG&E mitigated its damages and reduced them to an

amount less than the amount of the standby letter of credit that was available to be drawn. The bank supported its position by arguing that SDG&E's duty to mitigate its damages arose out of a contractual relationship between the bank, as issuer, and SDG&E, as beneficiary.

Affirming the lower court's decision, the Court of Appeal rejected the argument that a contractual relationship is created between an issuing bank and the beneficiary of a standby letter of credit. The relationship is better understood, the court reasoned, as a statutory relationship created by Article of the California Uniform Commercial Code (the CUCC) and the incorporation, in the text of the standby letter of credit, of the "record of customs and practice" that is reflected in UCP 400 Article 3 ("Credits v. Contracts"), 4 ("Documents v. Goods/Services/Performances"), and 10 ("Liability of Issuing and Confirming banks"). As a statutory relationship, it "is not subject to analysis under ordinary contract principles such as those relating to mitigation of damages".

The court also rejected the theory behind the bank's remaining arguments, relying on the principle of "independence" that is codified in the CUCC and reflected in the UCP. It noted that the UCP expresses the independence principle by stating that: (i) "Credits, by their nature, are separate transactions from the sales or other contract(s) on which they may be based" (Article 3) (ii); in Credit operations all parties concerned deal with documents, and not with goods, services and/or other performances to which the documents, and with goods, services and/or other performances to which the documents may relate" (Article 4); and (iii) "An irrevocable letter of credit constitutes a

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461 The rules of this code are substantially the same as the UCC.

462 UCP 500 had not become effective at the time of the dishonour at issue in this case.
definite undertaking of the issuing bank, provided that the stipulated documents are presented and the terms and conditions of the credit are complied with."

Recognising the importance of preserving the utility of standby letters of credit as commercial instruments, the court declined to impose a duty to mitigate damages on the beneficiary of a standby letter of credit, or to permit an issuing bank to inquire "into the underlying contractual dispute". It seems that the court in this case took a similar approach to that of the court in *Cargill International S.A. Antigua Geneva Branch And Another v. Bangladesh Sugar & Food Industries Corporation*[^463] in rejecting the bank's entitlement to dishonour the standby letter of credit merely because the beneficiary could not show any damages. The court believed that this would undermine the certainty of payment that makes standby letters of credit so appealing to persons engaged in commerce and would also undermine the commercial utility of these instruments. Moreover, permitting or requiring an issuing bank to inquire into the underlying contractual dispute would also place the bank, which has much less information concerning the underlying contract than do either the beneficiary or the account party, in the position of analysing the contract documents. This would be, from a policy standpoint, an inefficient division of responsibilities in a contractual dispute that ideally should be resolved between the two parties to the contract.

This case indicates that the court concluded, citing and strongly supporting the independence principle, that the beneficiary is under no duty to mitigate its damages before drawing on the standby letter of credit. Likewise, the court held that the amount permitted to be drawn under the standby letter

of credit should not be reduced even if a beneficiary does mitigate its damages.

The courts decisions in the cases discussed above emphasise the legal nature of the bank's obligation to pay under the letters of guarantee as an independent undertaking to pay the amount of the letter of guarantee regardless of the fact of whether or not the beneficiary has incurred any damages. This question and the question of what is the true amount of the damages sustained by the beneficiary as a result of the account party's default must be beyond the bank's concerns. Any conduct by the bank to the contrary would be interpreted as an interference by the bank in the underlying relationship of the parties and would also contradict the commercial purpose of these instruments. The bank, therefore, should avoid being involved in the parties' conflicts. It should pay, provided it receives a demand which conforms to the terms and the conditions of the letter of guarantee.

It is crucial to bear in mind that limitation of liability as provided by Articles 11-14 of the URDG cannot be effective without the application of Art. 15 of the same rules. This article imposes a general duty on the bank to act in good faith and with reasonable care. The bank according to this article would not be able to exempt itself from liabilities or responsibilities as provided by the rules if it failed to act in good faith and with reasonable care.464 The requirement of acting in good faith and with reasonable care as a condition for benefiting from the limitation of liabilities might raise the

464 Art. 15 of the URDG provides that: "Guarantors and Instructing Parties shall not be excluded from liability or responsibility under the terms of Articles 11, 12, and 14 above for their failure to act in good faith and with reasonable care". In the case of a Stand by letter of credit which is governed by the UCP 500 Rules, banks limitation of liabilities are governed by Articles 15-18 which in principle provides the same degree of limitation as the URDG. See also Ellinger E.P., "The Uniform Customs and Practice for Documentary Credits-the 1993 Revision" [1995] Lloyd's Maritime and Commercial Law Quarterly, 377 at p.391.
question the meaning of these terms. It seems very difficult to produce a uniform definition for what is meant by both terms. To be able to decide whether or not the bank had acted with in the acceptable standards of good faith and reasonable care reference should be made to the governing law, the terms of the letter of guarantee, and the surrounding circumstances. In Selangor United Rubber Estates Ltd. v. Cradock and others (No.3), the question arose as to the nature and the extent of the contractual duty of care owned by a paying bank to its customer. In this case Ungoed-Thomas J. said:

"... a bank has a duty under its contract with its customer to exercise "reasonable care and skill" in carrying out its part with regard to operations within its contract with its customer. The standard of that reasonable care and skill is an objective standard applicable to bankers. Whether or not it has been attained in any particular case has to be decided in the light of all relevant facts, which can vary almost infinitely". The significance of the bank's duty to act in good faith and with reasonable care entails that this duty could not be

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465 Art. 14 of the Uncitral convention provides that: "The guarantor/issuer shall act in good faith and exercise reasonable care": Article 5-102(a)(7) of the UCC defines the term "good faith" as "Good faith" means honesty in fact in the conduct or transaction concerned.

466 Article 13 of the Uncitral convention provides that rights and obligations of the guarantor/issuer and the beneficiary shall be"determined by the terms and conditions set forth in the undertaking...". See also Gorton L.. "Draft Uncitral Convention On Independent Guarantees"[1996] Lloyd's Maritime and Commercial Law Quarterly 43.

467 See Cresswell P., Blair W., Hill G. and Wood P., (eds.), Encyclopedia of Banking Law (1992) at para. C. 20.3.; See also, for example, National Bank of Greece S.A v. Pinios Shipping Co. No.1. (The Maria) [1990] 1 AC 637, [1989] 1 All ER 213, in which the Court of Appeal held that on the facts the bank did not owe its ship owner customer a duty either in contract or in tort to ensure that the relevant ship was adequately insured by a third party.


altered or modified by the parties own consent. The bank, however, should not be allowed to escape liability by merely relying on the notions of "good faith" and "reasonable care". It can be suggested therefore that the bank should not act with a "pure heart and empty head" it should rather show that it had made every possible effort to protect the parties interests under the letter of guarantee. If the court according to the facts of case and the surrounding circumstances was convinced of the quality and the standards of the banks precautions, then and only then, the bank deserves to be exempted from liability to the extent that it does not harm the other parties interests. In order to avoid the wide effect of exemption clauses, one would be inclined to propose an approach similar to the one taken by Article 5-103(c) of the UCC which considers any provision in the reimbursement that "generally" excuses the bank from liability under the standby letter of credit or "generally limiting remedies for failure to perform obligations" as ineffective. The application of this approach will no doubt mitigate the wide effect of exemption clauses that allow a bank to escape liability by simply showing that it acted in good faith and with reasonable care.

5.5 Reliance on Exemption Clauses.

The majority of letters of guarantee are issued in support of international transactions and are furnished in an indirect manner. In the case

470 According to Article 13 of the Uncitral Convention, the rights and obligations of the guarantor and the beneficiary shall be "determined by the terms and conditions set forth in the undertaking, including any rules, general conditions or usages specifically referred to therein, and by the provisions of this Convention": See also Gorton L., supra, at p. 48; Goode R., Guide to the ICC Uniform Rules for Demand Guarantees, supra, at p. 31.

471 Article 5-103(c) of the UCC provides that: "A term in agreement or undertaking generally excusing liability or generally limiting remedies for failure to perform obligations is not sufficient to vary obligations prescribed by this article".
of an indirect letter of guarantee, the contract between the bank and its customer normally includes a clause reserving the bank's right to act through a correspondent. The correspondent's involvement could lead to some mistakes that would place the account party in a very difficult position. Such mistakes could, for example, take the form of payment against the letter of guarantee beyond its expiry date, or payment by the correspondent bank in accordance with forged or falsified documents. The use of the correspondent bank's services could raise the question of the possibility of considering the instructing bank responsible for its correspondent's acts and omissions.

In principle, at common law the account party seems to face no problem in suing his bank for its correspondent's default or negligence. The point was raised in respect of the engagement of a correspondent bank by issuing a letter of credit and settled by the House of Lords in 1927, in the well-known case of Equitable Trust Co. of New York v. Dawson Partners Ltd.\textsuperscript{472} In this case the customers had themselves nominated the correspondent, and the failure there was due to an error in decoding the cable containing the instructions of the applicant that the issuing bank had transmitted to the correspondent bank. The customer stipulated that the beneficiary, \textit{inter alia}, was to present a certificate testifying to the quality of the purchase that was to be signed by "experts" but, due to the decoding error, the message received by the correspondent bank had mentioned a certificate signed by "an expert". Accordingly, the beneficiary submitted a draft accompanied by a certificate signed by a single expert which was honoured by the correspondent bank and accepted by the instructing/issuing bank. Due to a defect in the merchandise, the customer refused to reimburse the issuing bank.

The customer's refusal was justified by both the Court of Appeal and

\textsuperscript{472} (1927) 27 L.L.R. 49; (1926) L.L.R. 90 (C.A).
the House of Lords. It was decided unanimously by the House of Lords that the correspondent bank was not the agent of the customer even though it was he himself who selected it. This case indicates that the account party can turn to his own bank in order to sue it for any damages he might suffer as a result of the correspondent bank's negligence.

Nevertheless, in most cases, it is more likely that the account party would be unable to sue his bank for its correspondent's acts or omissions due to the presence of an exemption clause in their agreement. Most of the letters of guarantee application forms include such clauses.\(^ {473}\) The main object of these clauses is to delegate the risk of using the correspondent bank's services to the instructing bank's customer.\(^ {474}\)

The application of exemption clauses of this kind could raise some questions under English law system, such as whether these clauses could be affected by the Unfair Contract Terms Act of 1977 which is mainly concerned with regulating the use of clauses which exclude liability for failure to perform?\(^ {475}\)

This question seems to be controversial under English law and has given rise to two points of view. According to the first view, exemption clauses as provided by the URDG appear to satisfy the reasonableness test laid down in Section 11 of the Unfair Contract Terms Act. The reasonableness test as provided by the Act asks whether it is a fair and reasonable exemption clause having regard to the circumstances which were, or ought reasonably to

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\(^ {474}\) In general and for more on an exemption clauses of a wider scope and its effect, see, e.g., *Netherlands Trading Society v. Wayne and Haylitt Co.* (1952) 36 *Hong Kong Law Review* 109.

have been, known to or in the contemplation of the parties when the contract was made. According to this view the use of exemption clauses does not seem to contravene the Unfair Contract Terms Act, as the bank is not in a position to exercise any control over its correspondent. The other view argues that in spite of the existence of Art. 15 of the URDG, which mitigates the role of these exemption clauses by imposing the duty to act in good faith and with reasonable care such clauses might still be open to attack in England under the Unfair Contract Terms Act 1977. A similar stance was expressed by Professor Goode in dealing with the application of the exemption clauses to letter of credit transactions where he says that "So far as English law is concerned the UCP is subordinate to legislation, may be

476 Section 11(2) of Schedule 2 of the Unfair Contract Terms Act 1977 set forth certain guidelines to be taken into account by the courts in determining whether a clause satisfies the requirement of reasonableness test or not. These guidelines are as follows:" (a) the strength of the bargaining positions of the parties relative to each other, taking into account (among other things) alternative means by which the customer's requirements could have been met; (b) whether the customer received an inducement to agree to the term, or in accepting it had an opportunity of entering into a similar contract with other persons, but without having to accept a similar term; (c) whether the customer knew or ought reasonably to have known of the existence and extent of the term, (having regard, among other things, to any custom of the trade and any previous course of dealing between the parties); (d) where the term excludes or restricts any relevant liability if some condition is not complied with, whether it was reasonable at the time of the contract to expect that compliance with that condition would be practicable; (e) whether the goods were manufactured, processed or adapted to the special order of the customer".

477 Section (11) of the Unfair Contract Terms Act provides that:"The term shall have been a fair and reasonable one to be included having regard to the circumstances which were or ought reasonably to have been known to or in the contemplation of the parties when the contract was made.". See also e.g. Guest A.G. Chitty on Contracts, (27th edn., 1994) at para 33-308; Ellinger E.P. Modern Banking Law (2nd ed., 1994) at pp.369-70.


excluded or restricted by contract and if incorporated into the contract, as a set of contractual terms, subject to the courts normal powers, at common law and by statute to adjudicate upon the enforceability of contractual provisions.\textsuperscript{480} He concludes that "The width of these provisions is deplorable" and that the Articles are amount to a disclaimer by the instructing bank of responsibility for the acts and omissions of its own agents.\textsuperscript{481}

It seems that the type of risk the bank usually undertakes under an on-demand letter of guarantee makes the first view seem more plausible. Therefore, the strong possibility of a fraudulent or unfair demand by the beneficiary justifies the need for an exemption clause under which, for example, the bank absolves itself from the responsibility for the "form, sufficiency, accuracy, genuineness, falsification, or legal effect of any document" presented under the letter of guarantee. Moreover, it also seems very difficult for the instructing bank to control the acts of its correspondent in another country which is thousands of miles away. The exemption clause, therefore, seems to be fair and reasonable if the bank, at the time when the contract was made, explained the risks of issuing of such of letters of guarantee to its customer.\textsuperscript{482} Nevertheless, it should be emphasised in this respect that the bank should not go too far by relying on these exemption clauses in a way that could harm its customer's interest. It should always do its best to protect and defend such interests.


\textsuperscript{481} Ibid.

\textsuperscript{482} See section 11(1) of the Unfair Contract Terms Act 1979; see also for e.g., \textit{Howard Marine and Dredging Co. Ltd. v. A. Ogden & Sons (Excavations) Ltd.}, [1978] Q.B. 574 at p. 594; \textit{George Mitchell (Chesterhall), Ltd. v. Finney Lock Seeds, Ltd.}, [1983] 3 W.L.R. 163, at p.171.
There is no doubt that the presence of exemption clauses could leave the account party in a delicate situation, where he might find himself able to sue neither his own bank, because of the clause, nor the correspondent bank due to the lack of a contractual relationship. This situation could lead to the account party to consider the possibility of the bank's negligence as a possible cause of action.

5.5 [1] A Bank's Negligent Performance of Services

A possible cause of action against the bank by its customer is negligence. A bank may perform certain services negligently causing financial loss to others, either the account party or the beneficiary. The bank, accordingly, should be held liable if it acts in a manner that clearly prejudices the interests of its customer, for example, putting telecommunication messages into the hands of incompetent or inexperienced personnel or taking documents known to be out of use in the trade.483

A bank's failure to exercise its duties under the letter of guarantee adequately will most probably result in an economic loss to the account party. The law of negligence relating to liability for causing an economic loss has traditionally only been applicable where the loss was caused by a negligent statement, as opposed to a negligent act.484 That was, in fact, the decision of the House of Lords in the leading case of *Hedley Byrne & Co. Ltd. v. Heller & Partners Ltd.*485 The facts of this case were that the respondent's bank was asked by the

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484 Professor Ellinger, in an attempt to find a cause of action examined the possibility of holding the intermediary bank, in the case of commercial letter of credit, liable for negligent misrepresentation if by reliance on this misrepresentation the buyer suffers a pecuniary loss; see Ellinger E.P. "Documentary Letter of Credit" at p. 236-8; see also the same author "Letters of Credit: Buyer Action Against the Confirming Banker" [1963] 26 M.L.R. 713; Penn, Shea and Arora. *The Law and Practice of International Banking* vol.2 at pp.344-5.
appellant's bank to give a reference about the financial position of one of the respondent's customer (Easipower Ltd). The reference, which was given without the respondent accepting responsibility for it, was satisfactory.

Relying on this the appellant (advising agents) entered into a transaction with Easipower, who later went into liquidation causing the appellant a loss of over seventeen thousand Sterling Pounds. The appellant brought an action for damages against the respondent alleging, inter alia, that the reference was given negligently by the respondent. The latter was proved to be negligent at the trial, but the House of Lords held that the appellants' action failed because the respondent gave the reference subject to a disclaimer of liability.

However, in this case the House of Lords expressed the opinion that damages for financial loss resulting from negligent misrepresentation would be awarded if the plaintiff proved that the defendant owed him a duty of care. The House of Lords further pointed out that such a duty of care would arise whenever there were contractual, fiduciary or other special relationships. No definite description was given by the House of Lords as to the nature of these special relationships but there were attempts to show how such a relationship could come into existence. Lord Morris stated that:

"it should now be regarded as settled that if someone possessed of a special skill undertakes, quite irrespective of contract, to apply that skill for assistance of another person who relies upon such skill, a duty of care will arise. The fact that the service is to be given by means of or by the instrumentality of words can make no


difference. Furthermore, if in a sphere in which a person is so placed that others could reasonably rely upon his judgment or his skill or upon his ability to make careful inquiry, a person take it upon himself to give information or advice to, or allows his information or advice to be passed on to, another person who, as he knows or should know, will place reliance upon it, then a duty of care will arise.488

Lord Reid also expressed the opinion that:

"I can see no logical stopping place short of all those relationships where it is plain that the party seeking information or advice was trusting the other to exercise such a degree of care as the circumstance required, where it was reasonable for him to do that, and where the other gave the information or advice when he knew or ought to have known that the inquirer was relying on him. I say 'ought to have known' because in questions of negligence we now apply the objective standard of what the reasonable man would have done."489

In the words of Lord Pearce:

"To import such a duty the representation must normally, I think, concern a business or professional transaction whose nature makes clear the gravity of the inquiry and the importance and influence attached to the answer."490

Lord Devlin also said:

"..relationships which ...are 'equivalent to contract, that is where there is an assumption of responsibility in circumstances in which, but for the absence of consideration, there would be a contract."491

488 Ibid., at pp. 502-3.
489 Ibid., at p. 486.
490 Ibid., at p. 539.
491 Ibid., at p. 529.
It follows from the above statements that in order for a duty of care to exist outside the contractual or fiduciary relationship a number of factors must be established. Firstly, the statement must be made in the course of a business or a profession and the person making it must have a special knowledge or skill in the subject matter. Secondly, the person who makes the statement must know or ought to know the importance of his statement and that the other person may rely on it. In other words he must assume responsibility. Thirdly, the recipient of the statement must prove that he relied on the statement and it was reasonable to do so.

We must examine whether these rules are applicable to the situation where the correspondent bank makes a negligent statement and the account party by relying on this statement sustains a financial loss. Firstly, the statement made by the correspondent bank must be connected to its professional involvement. Secondly, the correspondent bank must be aware of the importance of its statement and must know or ought to have known that the instructing bank would pass it to the account party, and the latter would be influenced by it in making his decision. So it should be held to have assumed liability. Thirdly, it must be clear that the account party will act on reliance on the correspondent bank's statement and he is justified in doing so.492

It seems from the preceding discussion that the correspondent bank could be held liable to the account party for its negligent mis-statement.

However, although the question of holding the correspondent bank liable to the account party in negligence has been raised in courts cases in the U.K. it has not been fully argued. In the *United Trading Corpns S.A v. Allied

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492 It should be noted that the Hedley case was concerned with a situation where information was requested, but it is not essential that the information is given as a result of a request; see, e.g., Percy R.A., Charlesworth and Percy on Negligence (9th ed. 1997).
Arab Bank Ltd. the issuing/correspondent bank was ordered to pay damages to the account party on the grounds that it failed to transfer the advance payments, remitted by the beneficiary, to the account party. Instead it had transferred the down payments to the main contractor, who had gone bankrupt. The submission, which was made on behalf of the account party, was that the issuing bank and all other banks in the chain would arguably be liable to the account party in the tort of negligence if they complied with the beneficiary’s demand which they knew to be fraudulent at the time of payment. This submission was accepted on behalf of the respondent as being arguable and on this basis the case proceeded. In GKN Contractors Ltd. v. Lloyd’s Bank Plc this point was also raised. Following the view of United Trading it was accepted by the Court of Appeal as being arguable. Parker L.J. in this case stated:

"That cause of action [tort of negligence] is one which I find some difficulty in appreciating, but, in view of the fact in this court in a case not yet reported [the United Trading case]... the existence of such a cause of action was considered arguable, for the purpose of the present appeal I take that it is also arguable." Parker L.J. in the above statement seems to suggest that if the point was fully considered no duty of care would be found. Jack citing I E Contractors Ltd v. Lloyd’s Bank Plc and Rafidian Bank also suggested that if the issue was to be actually decided, the intermediary/correspondent bank would not be held liable.

494 Ibid., at p.560.
496 Ibid., at p.62.
497 Jack R., Documentary Credits (2nd ed. 1993) at p. 287.
to owe a duty of care to the account party because there is no relationship between the two parties that could allow imposing such a duty.

It seems that the approach taken by American courts is similar to English courts in recognising the negligent mis-statement made by a person resulted in pecuniary loss to another as a cause of action even if there were no privity between them.499 One of the early cases in which this point was decided is *Glanzer v. Shepard*.500 In this case a firm of public weighers (the defendant) were requested by the seller to make a certificate of the weight of the goods and send a copy of it to the plaintiff. Relying on the weight certificate that was sent to him by the defendant the plaintiff purchased the goods. He later discovered that the weight of the goods was less than what the certificate stated it to be. In an action by the plaintiff to recover the money overpaid to the seller from the defendant (the firm of public weighers) the Courts of Appeals of New York held that the defendant was liable to the plaintiff. In this case Cardozo J. stated:

"....assumption of the task of weighing was the assumption of a duty to weigh carefully for the benefit of all whose conduct was to be governed. We do not need to state the duty in terms of contract of privity. Growing out of a contract, it has none the less an origin not exclusively contractual. Given the contract and the relation, the duty imposed by law."501

It was also stated:

"The defendants, acting, not casually nor as mere servants, but in the pursuit of an independent calling weighed and certified at the

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500 233 N.Y. 236, 136 N.E. 275 (1922).

501 135 N.E. at p.276.
order of one with the very end and aim of shaping the conduct of another. Diligence was owing, not only to him who ordered, but to him also who relied."

In order to succeed in an action for negligent misrepresentation the plaintiff must prove that the defendant owed him a duty of care. The mere reasonable expectation that the information may be passed to third parties is not sufficient to create a duty of care between the maker of the statement and these third parties. In *Ultrameres Corporation v. Touche, Niven & Co.* a firm of accountants (defendant) were requested to prepare a balance sheet of a company. The defendant knew that the balance sheet would be shown to third parties for the purpose of making some financial transaction. The defendant negligently prepared the balance sheet to show falsely that the company was in good financial condition. The plaintiffs, in reliance on the balance sheet, made several deals with the company. The company later failed and the plaintiffs sustained financial loss. In an action by the plaintiffs to recover their loss from the defendant, the court held that although the accountants firm were negligent in preparing the balance sheet, they did not owe any duty of care to the plaintiffs. Cardozo C.J., in giving his reasons for the dismissal of the action stated:

"If liability for negligence exists, a thoughtless slip or blunder, the failure to detect a theft or forgery beneath the cover of deceptive entries, may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class. The hazards of a business conducted on these terms are so extreme as to enkindle doubt whether a flaw may not exist in the implication of a duty that exposes to these consequences".

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502 Ibid., at p.277.

503 255 N.Y. 170, 174 (1931).

504 Ibid., at 174, 179.
Cardozo C.J’s fear of imposing unlimited liability upon the person who makes a negligent misrepresentation was recognised by the Restatement of Torts Section 552(2) restricted the liability to loss suffered:

"(a) by the person or one of a limited group of persons for whose benefit and guidance he intends to supply the information or knows that the recipient intends to supply it; and (b) through reliance upon it in a transaction that he intends the information to influence or knows that the recipient so intends or in a substantially similar transaction."

The above discussion shows that the account party is able to use the bank's negligent performance as a cause of action against his own bank (the instructing bank). This raises the question of whether the account party is able to use the same cause of action in order to sue the correspondent bank for any loss he might suffer as a result of later's acts or omissions.

5.5[2] The Problem of Lack of Privity

The account party's attempt to sue the correspondent bank for damages under the common law rules might fail because of the lack of contractual relationship between him and the correspondent bank. This point could be illustrated by the case of Calico Printers Association Ltd. v. Barclays Bank Ltd.505 In this case, the plaintiffs engaged Barclays Bank as their agent for the correspondent of a bill of exchange, accompanied by commercial paper for goods, to the buyers. Barclays, in turn, engaged its correspondent, the AP Bank. As the bill was dishonoured, the plaintiffs ordered Barclays to arrange for the storing and insurance of the goods. This instruction was transmitted by Barclays to the AP Bank, which stored the goods but failed to insure them. When the goods were destroyed by fire, the

505 (1931) 36 Comm. Cas. 71.
plaintiffs sued the two banks for breach of contract and in negligence for their failure to adhere to their mandate. It was held that Barclays was not liable, as an exemption clause included in the contract between it and the plaintiffs exonerated it from liability for the negligence of its correspondents. The AP Bank was held not to be liable to the plaintiffs as there was no privity between them. Wright J observed that as a general rule there was no privity of contract between a principal and his agent's sub-agent. This ruling has been adopted by Webster J. in *Royal Products Ltd. v. Midland Bank Ltd.*,\(^{506}\) as regards the question of the relationship of the instructing bank and its bank correspondent.\(^{507}\) In this case it was said by Webster J. that the bank in carrying out its part of the transaction has a duty to use reasonable care and skill, and they would be vicariously liable for the breach of that duty by any servant or agent to whom they delegated the carrying out of the instructions.\(^{508}\)

A direct claim by the account party against the correspondent may fail, at least in England, due to absence of privity of contract. Although the correspondent bank is a sub-agent of the account party, he, the account party may not sue directly, under English contract law, the correspondent bank. According to this principle, "only a person who is a party to a contract can sue on it".\(^{509}\) Thus, since a customer is not a party to the contract between his bank and its correspondent, he is not entitled to sue the correspondent directly.

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for its mistakes. There is a considerable authority in English law to the effect that an agent is liable to his principal for the default of a sub-agent, but because of the absence of privity of contract, the sub-agent is not directly liable to the principal.510

Scots law recognises the right of a third party to sue under a contract. The *jus quaesitum tertio* doctrine511 in Scots law permits such a claim in certain circumstances. The requirement is that there must be a *pactum in favorem tertii*. Moreover, it was held that a *jus quaesitum* must be irrevocable.512 The parties to a contract may confer a right on a third party if they intended to do so. It is not enough for the third party to show that he incidentally benefits. Therefore, if such conditions are met in the agreement between the instructing bank and its correspondent, the account party although not party to that agreement, is entitled to enforce performance of the agreement according to its terms,513 or recover damages for non-performance,514 if such agreement conferred upon him a right. It is, however, arguable that such agreement does confer a right upon the account party.

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511 It was held in Hill Samuel & Co. Ltd. v. Laing [1989] S.L.T. 760 at p.763 that "[t]he phrase 'jus quaesitum tertio' may be used in two senses: it may relate to the right to sue on a contract, and it may also relate to having a right to property derived from a contract." The court referred to Gloag on Contracts (2nd ed.), at 234-235.


In U.S law, the correspondent bank is deemed to have privity of contract with the customer of the bank by which it is engaged. The point is illustrated by two American authorities. In the first case Silverstein v. Chartered Bank the instructing bank was held to have privity of contract with his bank's correspondent as the latter had been expressly selected by him. The second case is Securities Fund Services Inc. v. American National Bank and Trust Co. In this case a rental was due under a charter party at the Bank de Paris in Geneva at a predetermined time. The charterer ordered his bank in Chicago to effect the transfer. A telex message was duly transmitted by the London branch of the Chicago bank to its correspondent in Geneva, the defendants. Owing to the fact that the defendants' telex terminal in Geneva ran out of paper, the message was not received, although the terminal automatically acknowledged the message to the transferring bank's branch in London. When the breakdown was discovered, the time for the payment of the amount to the ship owners' bank, the Banque de Paris in Geneva, was over. The ship owner accordingly withdrew the ship. The charterer then brought an action against the correspondent bank, the defendants in Illinois.

The above discussion shows that the account party, under English law, has no right against the correspondent bank. Such lack of contractual relationship will give rise to the following difficulty what is the position of the account party if he suffers a financial loss as a result of the correspondent bank's failure to do its duty? Such loss could be incurred as a result of failing

is entitled to recover damages for non-performance. However, Gloag, Contract (2nd ed.), at p.239, thinks he is not.


517 Ellinger E.P., Modern Banking Law, supra, at p.452.
to issue the letter of guarantee at all, on issuing the letter of guarantee too late, which causes the account party to incur a financial loss as a result of losing the contract.

It follows therefore that, under common law rules, the account party will then find himself in a position where he is unable to sue the issuing/correspondent bank for damages in the event of the latter paying beyond the letter of guarantee's expiry date. In one letter of credit case the court held that the account party could not sue an issuing/correspondent bank that had paid on a forged draft and refused to honour the genuine one, as there was no privity of contract.518 The only exception to this rule would appear to be where the issuing/correspondent bank is itself guilty of fraud by allowing the beneficiary to make his demand under known forged documents, or for purposes other than those stipulated under the letter of guarantee.519

It may be concluded from the above discussion, that the absence of privity of contract between the account party and the issuing/correspondent bank makes the situation too difficult for the account party where there is an exemption clause covering the liability of the instructing bank for the errors of the issuing bank. It seems, therefore, wrong and unjust to leave the account party without a remedy. One might therefore suggest that denying the account party the right to sue his own bank for the acts and omissions of its correspondent appears to be unreasonable, especially since it is the instructing bank which normally selects its correspondent.520 How this situation be rectified? In the


first place it might be suggested that exemption clauses as provided by ICC rules should not be permitted to operate in circumstances where the instructing bank has been negligent, for example, in transmitting or formulating instructions to the issuing bank. The same obtains where the issuing banker refrains from taking reasonable steps to protect the account parties' interests, and where he does not exercise due diligence in his efforts to prevent the issuing bank, with whom he has clear privity, from honouring the letter of guarantee in circumstances where such action might have prevented payment to the beneficiary. These qualifications should apply even in cases where the issuing bank was selected by the account party. In other words, Articles 11-14 of the URDG should only apply where circumstances beyond the control of the instructing bank, and/or which it could not have reasonably been expected to avert, cause the wrongful advice or payment to the account party. Such a restricted construction of the relevant URDG provisions is generally permissible on public policy grounds even in jurisdictions where no specific legislation circumscribing the effect of standard contract exemptions, such as the Unfair Contract Terms Act 1977, is to be found. By way of caution, it should be made clear that the UCP or the URDG rules in similar situations should not be understood to be a blanket exemption of liability on the part of the banks. The lack of privity between the account party and issuing/correspondent bank should not be construed as giving it a permission to act with gross negligence. It could be argued here that could be made in this regard is that the account party should be allowed to sue the issuing/correspondent bank's for negligence. It has been suggested that if the issuing/correspondent bank breach is serious, the court should feel free to invoke the common law rule of fundamental breach to limit the exempting terms, and/or to declare that such terms fails to satisfy the requirements of
reasonableness for the purpose of the Unfair Contract Terms Act 1977 and are thus ineffective under Section (3) of the Act.

Moreover, the instructing bank should be under a duty to recover from its correspondent. And it should take all reasonable steps at its disposal in order to defend the interests of its customer. Therefore, if there were negligence in the instructions given to the issuing bank or in actions which could have been taken to insure the fulfillment of such instructions, the instructing bank will not be able to rely on the exemption clause. The instructing bank, therefore, does not fulfill its obligation simply by sending a letter to the issuing bank. Rather, it must be the one to initiate litigation, including taking legal measures against the issuing bank.

The instructing bank may not transfer this burden of litigation to its client. The client hires the bank's services due to its purported proficiency in matters concerning letters of guarantee and the client entrusts the bank with his financial matters. The instructing bank selects a foreign bank to serve as its correspondent bank. Authorising the issuing bank to act does not terminate the instructing bank's duties. As long as the instructing bank can do something to defend its customer's interests it must do so. It is suggested, therefore, that the account party's risk can be reduced by expressly stipulating that his bank shall have the right to reimburse the issuing bank only after it examines the demand along with the accompanying documents itself, and it must not rely on the examination of documents by the correspondent/issuing bank.
CHAPTER SIX
Choice of Law and Letters of Guarantee

6.1 General

The international nature of letters of guarantee and their multiple contractual relationships may sometimes invoke a question of conflicts of law when disputes between the parties to the letter of guarantee arise. These rules normally come into play when the document under consideration does not specify the system of law that governs it and so such rules must be used to determine which system of law is to be applied by the courts to a question involving a foreign element.

There is no doubt that the law governing the contract will have a significant impact on a bank's obligations under the letter of guarantee including its obligation to pay. The law governing a letter of guarantee, for example, determines the question of whether or not expiry dates are enforceable. If according to that law expiry dates are not enforceable, payment cannot refused on the grounds that the call has been made after the expiry date.

The proper law of a letter of guarantee contract is determined in accordance with the principles which have been developed in English conflict of laws for determining the proper law of contract generally. These

521 Sometimes are referred to as "Private International Law".


principles will apply to determine the applicable law to the letters of guarantee which were entered into on or before April 1, 1991. For all contracts made after 1st April 1991 an English court must apply the provisions of the Contract (Applicable Law) Act 1990.

The purpose of this chapter is to examine *inter alia* the contractual choice of law rules in the light of their relevance to a letter of guarantee transaction. It will start by demonstrating briefly the general principles of the conflicts of law rules applied by the English courts in order to consider the impact of these rules on letters of guarantee transactions.

### 6.2 Applicable Law.

Conflict of law rules were originally developed by the common law and contractual issues under them are referred to as the "proper law" of the relevant contract. These common law rules are substantially reformulated as a result of the implementation in the United Kingdom of the Rome (EEC) Convention on the Law Applicable to Contractual Obligations 1980 ("the Rome Convention") in the Contracts (Applicable Law) Act 1990. The rules of that Convention, as implemented in the Act 1990, will determine the law applicable to a letter of guarantee which is issued after April 1, 1991.524 There will however be many cases involving contracts entered into before that date, which will continue to be governed by the common law rules.


6.2.1[a] Express Choice of Law.

In determining the proper law of the contract, English courts have relied on common law rules which had been developed by the courts on a case-by-case basis over the years. The common law rules shows that

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524 The date on which the Act entered into force: See Rome Convention, art.17. 198
whenever the courts were faced by the problem of applicable law they applied what was known as the doctrine of the "proper law of contract". This doctrine provides that the parties may choose the proper law with very little restriction on this right. This simply means that if the parties to a letter of guarantee have expressly stated which law shall apply, the court has only to apply the rules of that legal system to any disputes that arise. The parties power to choose, however, is subject to some restrictions as that the choice must not evade mandatory provisions of the lex fori, it must be "bona fide and legal", and there must be no reason for avoiding the choice on the ground of public policy.

An example here would be a choice of foreign law where the letter of guarantee transaction was wholly connected with England in order to avoid the Unfair Contract Terms Act 1977. In this case, the Act applies notwithstanding the choice of foreign law where inter alia the choice of law appears to have been imposed for the purpose of enabling the party imposing it to evade the application of the Act. But what would the situation be if the


527 Vita Food Products Inc. v. Unus Shipping Co. Ltd. [1939] A.C. 277 at p.290 per Lord Wright where he said "...where there is an express statement by the parties of their intention to select the law of the contract, it is difficult to see what qualifications are possible, provided the intention expressed is bona fide and legal, and provided there is no reason for avoiding the choice on the ground of public policy."; and see James Miller and Partners Ltd. v. Whitworth Street Estates (Manchester) Ltd. [1970] A.C. 583 at p.603.

528 Art 27(2) of the Unfair Contract Terms Act 1977 provides: "This Act has effect notwithstanding any contract term which applies or purports to apply the law of some country outside the United Kingdom, where (either or both) (a) the term appears to the court, or arbitrator or arbiter to have been imposed wholly or mainly for the purpose of enabling the party imposing it to evade the operation of this Act; or (b) in the making of the contract one of the parties dealt as consumer, and he was then habitually resident in the United Kingdom, and the essential steps necessary for the making of the contract were taken there, whether by him or by others on his behalf."
parties to a letter of guarantee did not express their intentions as to what law should apply to the contract? And how then does the court resolve the issue at hand? 529

6.2.1[b] Where there is no Express Stipulation on the Law Applicable to the Contract

Where there is no valid express choice of a proper law, 530 the court will consider whether the parties of the letter of guarantee have by implication come to an agreement 531 as to what should be the proper law. 532 In order to determine the proper law of the contract where no choice is expressed by the parties the courts have resorted to the use of inferred and imputed choice of law. The two choices involve a subjective and an objective standard respectively. 533 In the first place, the proper law may be inferred or implied by reference to the terms of the contract and the circumstances surrounding its making. 534 Several factors have to be taken into account in implying a choice.


530 This includes those situations where the parties have attempted to make an express choice but have failed to do so with sufficient clarity. Compagnie d'Armement Maritime S.A. v. Compagnie Tunisienne de Navigation S.A. [1971] A.C. 572.

531 There must be actual agreement on the point: James Miller and Partners Ltd. v. Whitworth Street Estates (Manchester) Ltd. [1970] A.C. 583 at p. 603.


533 See North P.M. & Fawcett J.J., Private International Law, (1992), at p. 459 where he states that "The twin theories which underlie the proper law were therefore the subjective theory, which looked to the intentions of the parties, and the objective theory which sought to localise the contract."

534 About these facts and circumstance of contract see Schmitthoff C.M, The English Conflict of Laws, (3rd edn. 1954) pp. 110-11. He states that: "Amongst them are: the place where the contract has been concluded, the place where the contract has to be performed, the language and terminology employed by the parties, the subject matter of the contract, a submission to arbitration, the situation of the funds which are liable for the discharge, or security of the obligation, a connection with a preceding transaction by a particular legal system."
Some of these factors are, for example, if the parties agreed in their contract that the courts of a given country shall have jurisdiction in any matters arising out of their contract or if they agree that arbitration shall take place in a given country. Reference to the factors that help the court to find the implied applicable law was made by the court in *Ilyssia Compania Naviera S.A. v. Ahmed Abudul-Qawi Bamaodaia.* In this case the court considered the facts that the parties' agreement to arbitrate their differences in London and according to the Arbitration Act 1950 as showing an inferred intention of the parties to have their contract governed by English law. It should be noted in this respect that no single aspect of the contract is decisive; instead, a wide range of different factors must be taken into account, and their importance may vary according to the type of letter of guarantee in question and the individual circumstances of the case.

It seems that the problem with the inferred or implied choice is that the court must discover what the intention of both parties was when they addressed the choice of law question at the time of making the contract. The court cannot arrive at the presumed intention of the parties unless it is satisfied that both parties would have chosen that law. It is not an easy task to accomplish for one party may refuse to accept the undeclared intention of the

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536 Ibid. at 112; see also *The St.Joseph* (1933) 45 L.I.L.Rep. 180.
537 See generally Dicey and Morris, supra, p.1182; Cheshire and North, supra, p.457.
other party. This, however, is not a major problem for the court or at least it should not be, since the test is one of 'reasonable' persons. 538

Before discussing the objective test one must consider briefly the factors that may be considered in order to imply or infer the applicable law. The court may draw a strong inference that the parties have selected English law as the proper law from the fact that they have for example selected England as the place whose courts will determine disputes arising out of their contract or where arbitration will take place. 539 Other relevant factors not already mentioned include the form, language and terminology of the letter of guarantee contract, the currency in which the amount of the letter guarantee discharged, 541 the existence of other related agreements between the same parties or involving the same subject matter, the general course of dealing and conduct of the parties up to the time of the contract, though not subsequent thereto, 543 and the nationality of each party. 544 This inference should be applied with caution as countervailing factors may exist to rebut it, 545 so that whereas the use of the English language, for example, at one time


543 James Miller and Partners Ltd. v. Whitworth Street Estates (Manchester) Ltd. [1970] A.C. 583

used to be considered as important in making such proper law inferences it has declined in importance since English has become the common language of international commerce. Likewise, the fact that a contract is contained in an English standard form document is no longer as important a factor as it used to be due to the frequent use of such forms throughout the world in international business transactions. The same considerations apply to the weight to be given to the currency and place of payment since Sterling and U.S. dollars, for example, are frequently used as the currency of payment in international trade. In deciding this issue, therefore, the letter of guarantee contract requires to be regarded as a whole.

6.2.1[c] Absence of express or implied choice:

Where the proper law of the letter of guarantee has not been expressly or impliedly chosen, the court should select the proper law according to the country or system of law with which the letter of guarantee transaction has its "closest and most real connection." The English courts, therefore, show a tendency to be unwilling to apply the principle of presumed intention of the parties and adopt the objective test


546 In Amine Rasheed Shipping Corp. v. Kuwaiti Insurance Co. [1984] A.C. 50, the fact that the policy was in English was not given any weight at all.


548 It has been said that whether it is the "system of law" or the "country" that must be considered depends on the circumstances: James Miller and Partners Ltd. v. Whitworth Street Estates (Manchester) Ltd. [1970] A.C. 583. 603-604. 606; Rossano v. Manufacturers Life Insurance Co. [1963] 2 Q.B. 352. 360-362; Savers v. International Drilling Co. N.V. [1971] 1 W.L.R. 1176. 1180-1181. 1183; Coast Lines Ltd. v. Hudig and Veder Chartering N.V. [1972] 2 Q.B. 34. 44. 46.

that in the absence of the express choice of the parties, the proper law of the contract means the system of law with which the transaction has its closest and most real connection.\textsuperscript{550} According to this theory, the court must find the law by reference to objective criteria. This method is believed to avoid the problem for the court of ascertaining the actual subjective intent of the parties because they may not have considered the question of choice of law. If the court attempts to determine what law the parties would have chosen had they focussed their attention to the question an impasse could result.\textsuperscript{551} Their intention must therefore be attributed to the contractors as reasonable persons.\textsuperscript{552}

In the event that the parties do not indicate which law governs the contract, and their intention cannot be ascertained from the terms of the contract, then the court has to decide on the legal system with which the contract has its closest and most real connection.\textsuperscript{553} It must be pointed out that

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\textsuperscript{551} \textit{The Assunzione}. supra. at pp.176. 185-86.
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\textsuperscript{552} Cheshire G., "The significance of the Assunzione". [1957] The British Year Book of Int'l L. 123 where he says[/T]hey themselves have by their own acts localised the contract in the sense that by establishing a number of connecting factors with this or that country they have placed its centre of gravity in the country where those factors are most enduring and most impressive.
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the court in arriving at the system of law with the closest and most real connection to the contract uses the same or similar factors as those employed by the implied choice theory. In this case the court will ascertain the proper law objectively\textsuperscript{554} in the light of the facts and circumstances of each case,\textsuperscript{555} including the place of contracting, the place of performance, the place of residence or business of the parties and the nature and subject matter of the contract. The court will also take into account the wording of the contract, the style in which it is drafted and even the language used, the forms used and indication of the place of arbitration.\textsuperscript{556}

The test of proper law in case of absence of an expressed choice of law, under English common law rules, was laid down in a letter of credit case \textit{Off-shore International S.A. v. Banco Central S.A.}\textsuperscript{557} In this case, it was decided by the court that the proper law of a documentary credit is that of place of payment, being the law with which the transaction has its closest and most real connection. In this case, a letter of credit was opened by Spanish defendants in Spain in favour of the plaintiffs who were doing business in the United States. The credit was a payment for construction of an oil rig and was advised by a New York bank. A dispute arose and it was discovered that there

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\textsuperscript{554} See North P.M. & Fawcett J.J., supra, at p.459 where he states that "The twin theories which underlie the proper law were therefore the subjective theory, which looked to the intentions of the parties, and the objective theory which sought to localise the contract."


\textsuperscript{556} In the United States of America a preference was formerly shown for a rigid and inflexible test, represented by the place of contracting in some of the States but the place of performing in others; see North P.M. & Fawcett J.J., supra, at p.449 where they also quote Auten v. Auten (1954) 308 NY 155, 124 NE 2d 99, Haines v. Mid-Century Insurance Co.177 NW 2d 328 (1970).

\textsuperscript{557} [1976] 1 W.L.R 399. In \textit{Power Curber International Ltd. v. National Bank of Kuwait SAK} [1981] 1 WLR 1233, the Court of Appeal held that \textit{Offshore International} correctly decided and (by a majority) that a debt under a letter of credit is situate in the place where it is in fact payable against documents.
was no provision in the credit for the applicable law. The court had to decide whether Spanish or New York State law applied to the dispute. Ackner J., as then he was, stated:

"The letter of credit contained no express provision as to the system of law which was to be applied to it. In such circumstances, it is common ground that the letter of credit is governed by the system of law by which it has its closest and most real connection."558

Applying this principle to the facts, the learned judge found that the New York law was revealed as the proper and applicable law of the contract. Ackner L.J. reasoned that since New York State was the place of business of the advising bank and the payment was to be made there in United States dollars, upon presentation of the proper documents there, it was clear that the letter of credit had its closest and real connection to the law of New York State.

The decision in the Off-shore International case was also affirmed by the House of Lords in Power Curber International Ltd. v. National Bank of Kuwait.559 In this case, a distributor company in Kuwait bought equipment from Power Curber, a company doing business in North Carolina. The National bank of Kuwait issued an irrevocable letter of credit which was advised by the Bank of America in Miami through a bank in Charlotte, North Carolina. Power Curber thereafter delivered the machinery. The buyers then raised a counterclaim against the sellers and Kuwait courts awarded a

558 Ibid, at 401.

559 [1981] 2 Lloyd's Rep. 394. In this case it was said by Lord Denning M.R.:"(The defendants) sought to say that Off-shore International S.A. v. Banco Central S.A. (above) decided by Ackner J. was either wrongly decided or was distinguishable. But I think the case was rightly decided and cannot be distinguished on any valid ground." ibid at p. 399.
provisional attachment order, thereby preventing the Kuwait bank from paying under the credit. The sellers thereupon sued the bank, which had a registered branch in London, in the English courts. Paker J. gave summary judgment against the bank. The Court of Appeal upheld Paker's J. decision and said that the decision of the court in Kuwait did not affect the obligation of the bank to honour the credit.

In this case Lord Denning said:

"With what law has the contract its closest and most real connection? In my opinion it was the law of North Carolina where payment was to be made (on behalf of the issuing bank) against presentation of documents... A debt under a letter of credit is different from ordinary debts. They may be situated where the debtor is resident. But a debt under a letter of credit is situated in the place whether it is in fact payable against documents." 560

Griffiths LJ, in the same case, took a similar view:

"In my view the proper law of the letter of credit was the law of the state of North Carolina. Under the letter of credit the bank accepted the obligation of paying or arranging the payment of the sums due in American dollars against presentation of documents at the seller's bank in North Carolina." 561

The approach taken by both judges in the case is an application of the common law rules in the absence of choice of law in the contract. Both of them considered some factors such as the place of payment of the letter of credit and the currency in which the letter of credit is to be paid as indications to law of the place to which the letter of credit is most closely connected. It can also be concluded that the court's decision lays down a general principle which almost always lead to the application of law of the place where the

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560 Ibid. at p. 397.

561 Ibid. at p. 398.
issuing bank is situated. By analogy the same principle is most likely to be applied to letters of guarantee. Thus it appears that in relation to a letter of guarantee, the contract between the beneficiary thereunder and the issuing bank will be regarded as being most closely connected with the law of the country where payment is to be made following a demand from the beneficiary.

In conclusion, it seems that according to English common rules, English courts will determine the proper law of the contract, including a letter of guarantee, in three ways:

(1) by express selection by the parties;
(2) by inferred selection from the circumstances or failing either of these,
(3) by judicial determination of the system of law with which the transaction has the closest and most real connection.

As previously stated, the common law rules have been largely replaced by the provisions of the EEC Convention on the Law Applicable to Contractual Obligations 1980, which is known as the Rome Convention. For all of contracts made after 1st April 1991 an English court must apply the


564 It is believed that the traditional common law rules will continue to be applied even to contracts made after the convention came into force in a number of situations. English courts will therefore have to operate two different regimes for contract choice of law; see. North P.M. & Fawcett J.J., supra. (1992) at p.461; See also Anton A.E & Beaumont P.R. Private International Law. (1990) at. p.260.(Scots Law)

6.3 The Rome Convention

Under the Convention, the letter of guarantee contract is governed by the law chosen by the parties, either explicitly or implicitly. Article 3(1) of the Convention provides:

"A contract shall be governed by the law chosen by the parties. The choice must be expressed or demonstrated with reasonable certainty by the terms of the contract, or circumstances of the case. By their choice, the parties can select the law applicable to the whole or a part only of the contract."

As a result where a letter of guarantee contains a choice of law satisfying Article 3(1), the chosen law will apply except to the extent that freedom of choice of law is restricted by other provisions of the Convention.565 A choice of law by the parties "must be expressed or demonstrated with reasonable certainty by the terms of the contract or the circumstances of the case."566 There is normally no difficulty in determining whether a contract contains an express choice of law. It is suggested that including phrases as the contract is "governed by", or "to be constructed in accordance with", or "subject to" a particular law is to be as a valid express choice of law by the parties.567

The proper law doctrine under English common law principles is not lost in the convention. The convention states that where the parties have not

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565 See for example Art.3(3) which provides: "The fact that the parties have chosen a foreign law, whether or not accompanied by the notice of a foreign tribunal, shall not, where all the other elements relevant to the situation at the time of the choice are connected with one country only, prejudice the application of rules of the law of that country which cannot be derogated from by contract, hereinafter called 'mandatory rules'.

566 Art.3(1) of the Convention.


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made an express choice of law, an implied choice of law may be implied from the terms of the contract and the circumstances surrounding the case. If this is not possible, the convention seeks to establish the country with which the contract is most closely connected. Accordingly, in the absence of a choice of law by the parties, regard has to be made to the presumption in Art. 4(2) which provides:

"Subject to the provisions of paragraph 5 of this Article, it shall be presumed that the contract is most closely connected with the country where the party who is to effect the performance which characteristic of the contract has, at the time of conclusion of the contract, his habitual residence, or, in the case of a body corporate or unincorporate, its central administration. However, if the contract is entered into in the course of that party's trade or profession, that country shall be the country in which the principal place of business is situated or, where under the terms of the contract the performance is to be effected through a place of business other than the principal place of business, the country in which that other place of business situated."

According to the above mentioned article the letter of guarantee contract is most closely connected with the principal place of business of the party who is to effect the performance which is characteristic of the contract or, where the performance is to be effected through another place of business, the country in which that other place of business is situated. The application of the article requires the characteristic performance of the relevant contract (letter of guarantee, letter of credit, insurance, etc.) to be identified. The convention, however, gives no help as to how to determine what is the characteristic performance of any particular contract. Some assistance could

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568 Art. 4(2).
be obtained by the reference to the Report by Prof. Giuliano and Legarde published in the Official Journal of Communities of 31st October 1980.570 The Report explains the characteristic performance in the case of a bilateral (reciprocal) contract as "...the counter performance by one of the parties in a modern economy usually takes the form of money. This is not, of course, the characteristic performance of the contract. It is the performance for which payments is due, i.e., depending on the type of the contract, the delivery of the goods..the provision of a service, transport, insurance, banking operations, security, etc..which usually constitute the centre of gravity and the socio-economic function of the contractual transaction."571 This simply suggests that the characteristic performance of a contract is not the payment of money but the performance for which such payment is due. Although this general principle is clear, its application to a letter of guarantee seems to be problematic.572 The application of the notion of the characteristic performance in this sense may suggest that in the particular context of letter of guarantee the characteristic performance in a contract of letter of guarantee is that of the beneficiary, since he is the one who provides the performance for which the bank is required to pay the letter of guarantee and would contradict the presumed characteristic performance of a banking transaction as stated in the Report. Therefore, what appears to give useful further guidance for present purposes is that the Report states that "in a banking transaction the law of the country of the banking establishment will normally govern the contract."573

570 The contracts (Applicable law) Act provides by s.3(1), that in ascertaining the meaning or effect of the convention there may be considered the Report by Prof. Giuliano-Legarde published in the official journal of communities of 31st October 1980 (O.J.1980. No.C282/1).

571 Giuliano-Legarde Report, supra. at p.20.

572 This particular problem is not discussed in the Giuliano-Legarde Report.
The place of business of the bank through which the transaction is effected will be the presumptively applicable law.

It is to be noted that Art. 4(2) cannot apply at all if the characteristic performance of the contract cannot be determined. This is expressly stated in Art. 4(5) and in such situations the law of the country with which the contract most closely connected with the law of the country where payment thereunder is to be made. Accordingly, Art. 4(5) is relevant in the context of a letter of guarantee to the extent that the provision stipulates that the law indicated by Art. 4(2) "shall be disregarded if it appears from the circumstances as a whole that the contract is more closely connected with another country." In such circumstances the more closely connected country will provide for the applicable law. Bank of Baroda v. The Vysya Bank Ltd is a case in the point Vysya, a private bank in India, was instructed by an Indian importer, Aditya to issue a letter of credit in favour of Granada an Irish company with a London office, in respect of the purchase of pig iron. The credit was confirmed by the branch of the Bank of Baroda in London. When the documents first presented they were rejected by Granada for non-conformity, but after the documents were amended they were negotiated by Baroda, who paid Granada and sent the documents on to Vysya in India. Subsequently Vysya refused to reimburse Baroda on the ground that the documents were non-confirming. Accordingly the issue of applicable law was raised by the parties.


574 The authorities in the preceding note where the law of the place where payment was due against presentation of documents (i.e. the law of the country where the correspondent bank was situated) was said to be the most closely connected law.

It was argued by Baroda that the performance which was characteristic of the issuing/confirming bank contract was the addition in England of its confirmation to the credit and the honouring of its liability to the beneficiary, Granada. Vysya submitted, on the other hand, that the characteristic performance of the contract was Vysya's obligation to pay Baroda on presentation of confirming documents.

Mance J. agreed with Baroda's view and said even if the contract between Vysya and Baroda was concluded in India, its whole focus was on Baroda's London branch acting as confirming bank under the credit advised to the beneficiary in London. He consequently displaced the presumption under the convention that Indian law would apply; he felt that Art. 4.5 allowed the presumption to be overridden, as it appeared "from the circumstances as a whole that the contract was more closely connected with another country".576 The discussion will now turn to examine how an English court would decide what is the governing law of each of the contracts comprised in a letter of guarantee transaction.

6.4 LETTERS OF GUARANTEE AND THE APPLICABLE LAW.

It has been seen that letters of guarantee are contractual in their nature.577 It follows, therefore, that the general principles of conflict of law rules should apply equally to them.578 The application of the conflict of law

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576 Ibid at p. 93.


578 Some legal writers observe that the rules of autonomous letters of guarantee have been developed on an international level, away from domestic concepts and rules, and accordingly the rules of private international law are of little significance for autonomous letters of guarantee; Houtte H., The Law of International Trade, (1995) at p. 302.
rules on a letter of guarantee contractual relationship, however, may raise the question of whether a choice of law clause in one of the contracts could affect the rest of the contractual relationships under the letter of guarantee. For example, to what extent could the contract between the issuing bank and the beneficiary be affected by a choice of law clause in the underlying contract between the account party and the beneficiary?

6.5 The Proper Law of Each of the Independent Contracts of the Letter of Guarantee

The problems related to conflict of laws with regard to letters of guarantee have to be dealt with according to each of the autonomous contracts involved. The principles applicable to all the contracts are the same. In the absence of any express choice or indications which the courts can accept as being an indication of choice by the parties, all surrounding circumstances must be examined in order to find the system of law with which the letter of guarantee, or the particular aspect of the letter of guarantee, has the closest and most real connection.

There is a series of independent contractual relationships that exist as a result of a letter of guarantee transaction. These relationships exist between: the account party-bank, the beneficiary-bank and between the banks. The issue of the proper law of a letter of guarantee, therefore, may raise the question of whether the choice of law clause in one of contracts under a letter of guarantee transaction can be applied to other contracts under the same transaction in case of the absence of choice of law clause in one of these contracts.

There are only a few cases establishing the principles upon which a choice of law will be made in these relationships under letters of guarantee. In England there is a tendency among judges to deal with these choice of law
problems very much on the facts of a particular case, thereby avoiding laying down a general rule, which might well not work in subsequent case. Taking the basic principles already discussed and applying them to the contracts of a letter of guarantee the "proper law" situation must now be considered.

6.5.1 The Law Applicable to the Underlying Contract

As this is the basic contract between the parties a dispute between the two parties relating to the performance of this contract should be treated like any other contractual dispute. The court must establish from the terms of the contract whether the parties have expressed a choice on the applicable law or see whether by looking at the contract as a whole there is a legal system which appears to have a real and close connection with the contract on the basis of the facts already discussed. The question of whether the choice of law clause in the underlying contract should be applied to the letter of guarantee in case of the absence of such clause in the latter was examined by the court in The Broken Hill Proprietary Co. Ltd v. Xenakis. In this case, a charter-party contract between the parties provided for an arbitration in London, and was governed by English law. After an arbitration had been started, a letter of guarantee was issued by a third party [the defendant] to secure any sum found payable by the company [the plaintiff] as a result of the arbitration. Accordingly, the letter of guarantee was drawn up in London and signed in New York on behalf of the defendant. In the light of an absence of an expressed choice of the proper law, the court was required to decide the proper law of the letter of guarantee. Relying on the choice of law clause in


the charter-party contract the court decided that the letter of guarantee should
be also governed by the same law. In deciding on this point, Bingham J said:

"It seems to be quite plain that in the context of a primary
obligation, admittedly governed and being resolved according
to English law, the most likely implication would be that
guarantee was to be governed by the same law.... The
overwhelming inference in my judgment is that the guarantee
was to be governed by the same law that was governing the
charter party and the conduct of the arbitration." 581

The decision clearly shows that where there is no express of a choice
of law clause in the guarantee the judge can rely on the common law rules by
considering the expressed choice of law clause in the underlying contract (the
charter party). The judge also believed that the fact that the guarantee was
drawn in England made it more closely connected to the English legal
system. 582 He finally concluded that the guarantee should be governed by
English law.

The decision in The Broken Hill Proprietary Co. Ltd v. Xenakis 583
clearly shows that the court ignored the principle of independence between
the underlying contract and the letter of guarantee and consequently applied
the same governing law to both contracts. The English court took a different
view in the case of Attock Cement v. Romanian Bank. 584 In this case an
underlying contract was concluded between the parties which explicitly stated
that English law was the applicable law on the contract. Upon the instructions
of the account party, a letter of guarantee was issued by his bank to the benefit

581 Ibid at p. 306
582 Ibid; see also Chatterjee S.K., "The Method of Determining the Governing Law of Performance
of the beneficiaries. No provision on the applicable law was mentioned in the letter of guarantee. The account party's performance of the underlying contract was disputed by the beneficiaries and followed by a demand on the letter of guarantee. During the trial procedures, the beneficiaries contended that the letter of guarantee should be governed by the same law as the underlying contract. They based their contention on an oral agreement between the parties.\textsuperscript{585} The court rejected their argument and decided that the letter of guarantee should not be affected by the proper law of the underlying contract.\textsuperscript{586} Dealing with this point, Staughton L.J said:

"Almost every letter of credit or performance bond is issued pursuant to some underlying commercial transaction. Yet we were referred to no case where it had even been argued that one was affected by the proper law of the other. Seeing that the letter of credit or performance bond is intended to be a separate transaction, I would hold that it is not so affected, and is ordinarily governed by the law of the place where payment is to made under it."\textsuperscript{587}

Unlike the court's decision in \textit{The Broken Hill},\textsuperscript{588} the court in \textit{Attock Cement} \textsuperscript{589} recognised the the principle of independence between the underlying contract and the letter of guarantee and expressed an opposition to

\textsuperscript{585} Ibid at p. 579. The plaintiffs, alternatively, argued that the letter of guarantee should governed by the law of the underlying contract. They based their argument on principle stated in Dicey and Morris. \textit{The Conflict of Laws} (12th ed. 1993) at p.1185: "...the legal or commercial connection between one contract and another may enable the court to say that the parties must be held implicitly to have submitted both contracts to the same law" what makes the letter of guarantee governed implicitly by English law, was eventually rejected by the court. Their argument was rejected by the court.

\textsuperscript{586} Ibid at p. 581.

\textsuperscript{587} Ibid at p.573.

\textsuperscript{588} [1982] 2 Lloyd's Rep. 304 at p.306.

letting the letter of guarantee be affected by the choice of law clause in the underlying contract. The court also stated with approval that in case of an absence of an expressed choice of law clause the contract should be governed by the law of the place where payment is to be made under it.

It seems that the tendency of the court in *Attock Cement*[^590] is more consistent with the legal nature of the letter of guarantee contract which recognises the significance of the principle of independence of the contractual relationships under the letter of guarantee.[^591]

### 6.5.2 ACCOUNT PARTY - BANK RELATIONSHIP

The application for a letter of guarantee is usually made on a standard printed form, amended only to suit the particular requirements of the beneficiary. Thus in the terms of the letter of guarantee (as offered by the bank to the account party and accepted by him) a choice of law clause will have been inserted. However, it may well happen sometimes that there is no such term in the letter of guarantee. But even if this were the case, probably no great difficulty would arise in practice as, very frequently, the account party and the issuing bank will be found to be in the same country and therefore within the same jurisdiction. But suppose they were not in the same country. The court then has to consider which law has the closest connection with the letter of guarantee. In this respect the court has to take into account all the possible indicators available such as the place where the contract was concluded, the language in which it is drafted, the place of business of the parties and the place where the contract was performed. The reliance on these presumptions by the court will normally lead to the application of the law

[^590]: Ibid.

[^591]: Art.2 (b) of the URDG.
where the issuing bank carries on its business and from which it has provided the facilities. The basis for this is that that country is the one with which the closest connection to the contract. The issuing bank will be situated there, the letter of guarantee is issued there and, presumably, in the form and language of that country. In other words, it is the issuing bank that effects the performance which is characteristic of the contract. This approach is supported by the words of Staughton J. in Libyan Arab Foreign Bank v. Bankers Trust where he stated that:

"As a general rule the contract between a bank and its customer is governed by the law of the place where the account is kept, in the absence of agreement to the contrary.' The applicant will usually have an account with the issuing bank, and the one law will govern their relations both in respect of the account and such credits as the bank is requested to open."

But these presumptions may be rebutted, depending on the circumstances. So that if an applicant for the letter of guarantee asks a bank in a foreign country to open a letter of guarantee in favour of a party also outside the bank’s country and an issue arose for litigation between the applicant and the issuing bank, the law of the issuing bank would be greatly favoured, where no choice has been expressed. In arriving at the law applicable to the contract between the bank and the account party the English court will decide that the characteristic performance is of the bank and that accordingly the governing law is the law of the country in which the branch of the bank is situated.

592 See Article 4(2) of the Rome of the Convention; Jack R., Documentary Credits, supra, at p.302.


594 Ibid at p.270.
6.5.3 BANK-BENEFICIARY RELATIONSHIP

In most cases, the beneficiary and the issuing bank are likely to be in the same country. So that if the issuing bank refuses to pay and the beneficiary sues the bank, he will, very likely sue in his own country where both the bank and himself are resident. However, this situation may not exist in some instances and the beneficiary has to decide where to pursue the litigation. Sometimes, the paying bank may be situated in a different country from that of the beneficiary. In this case, no difficulty would seem to exist if an expressed choice of law was made in the letter of guarantee. In practice, however, it has been noted that the contract between the beneficiary and the paying bank is rarely subject to negotiation of the terms between the two parties. It is, therefore, not common to find mutual agreement on the proper law of their relationship.

Accordingly, in the absence of a choice of law clause, the courts must look for the legal system with the closest connection to the contract between the paying bank and the beneficiary, based on the general principles already discussed.

The governing law would be the law of the country in which the issuing bank, or issuing branch has its place of business, unless this can be rebutted by circumstances to the contrary.595 This is because the issuing bank will be the first to receive the demand and to examine the accompanied documents, if stipulated, and to determine acceptance or rejection of payment which is be considered as the characteristic performance of the contract.596

595 In Power Curber [1980] 2 Lloyd's Rep. 394, it was stated by Lord Denning that a debt under a documentary credit is situated in the place where it is in fact payable against documents; see also Attock Cement Co. Ltd v. Romanian Bank for Foreign Trade [1989] 1 Lloyd's Rep. at p.572.

596 See Art. 4(2) of the Rome Convention; Jack R., Documentary Credits, supra. (1993) at p.295
6.5.4 BANKS' RELATIONSHIP

In the case of indirect letters of guarantee the letter of guarantee is issued by a bank ordinarily located in the beneficiary's country, upon the request of the instructing bank which acts upon the instructions of the account party and is located in his country. To be able to issue a letter of guarantee in its own name, the issuing bank looks to the instructing bank to provide it with a counter letter of guarantee (or an indemnity).597

No difficulties are expected to arise if the applicable law was specified in the letter of guarantee and the counter letter of guarantee. In practice, however, it seems that counter letters of guarantee occasionally specify the applicable law. When a dispute arises and in the absence of a choice of law clause, courts are always asked to deal with question of the applicable law. In doing so, they are always faced by the principle of independence between the contractual relationships under the letter of guarantee.

The question of the applicable law on the counter letters of guarantee was for the first time raised in Turkiye Is Bankasi v. Bank of China.598 In this case, under building sub-contracts, the China State Construction Engineering Co. (CSC), a Chinese company, agreed to provide technical management and manpower for certain building projects to ETA Construction and Trading Co. Inc. (ETA), a Turkish company, which was head contractor in Libya. Under the subcontracts, CSC was required to provide performance letters of guarantee in favour of ETA, which they did at the request of the defendants,

597 The term "indemnity" is commonly used in English banking practice to denote the counter letters of guarantee.

to the plaintiffs, a Turkish bank. In order to facilitate the wording of counter-letters of guarantee, on 20 January 1983, the Turkish bank communicated to the Chinese bank, *inter alia*, that:

"For the sake of good order and in light of the Turkish legislation, we are sending you this time, attached hereto, together with the translated texts, already known to you, of specimen letters of guarantee most commonly used by us, the revised texts of the proposed drafts of counter guarantees...to be issued by your good selves in our favour, except in particular cases necessitating particular texts."599

Against these performance letters of guarantee, the Chinese bank agreed to issue counter-letters of guarantee. No express provision was made as to the proper law of these contracts of counter-letters of guarantee. At a subsequent date, ETA called on the plaintiffs under the performance letters of guarantee and the plaintiffs in turn called on the defendants under the counter-letters of guarantee, requesting them to remit the stipulated sums to their London branch. The defendants refused to act on the counter-letters of guarantee; the plaintiffs claimed the amount under them.

The question raised in this case was whether the law of Turkey was applicable to the action and if not what other law was applicable. In other words, the Commercial Court was required to consider what was the proper law of the counter-guarantees. On this point it was stated by Phillips J. that:

"In these circumstances, the first task of the Court is to determine whether the parties implicitly agreed upon the proper law. If they did not, the court then has to proceed to remedy this omission by deciding what proper law the parties would have been likely to have agreed, having regard in

particular to the system of law with which the relevant transactions had their closest and most real connection.\textsuperscript{600}

In dealing with the question of the proper law, the court was faced with the legal principle that counter letters of guarantee are independent of the primary letter of guarantee. Consequently, it had to decide if any connection between the choice of law clause in the letter of guarantee and the counter letters of guarantee. The court distinguished the decision of Staughton L.J in \textit{Attock Cement Co. Ltd v. Romanian Bank for Foreign Trade}, \textsuperscript{601} where the learned judge relied on the principle of independence in rejecting the argument that the letter of guarantee could be affected by the proper law of the underlying contract.\textsuperscript{602} The court found that the decision of \textit{The Broken Hill Pty. Co. Ltd. v. Xenakis} \textsuperscript{603} case was "more closely analogous".\textsuperscript{604} The defendants on their side argued that "As a matter of general principle a bank that gives a counter-guarantee in an international banking transaction is contractually obliged and entitled to honour that counter letter of guarantee at its own place of business"\textsuperscript{605} and they asked the court to apply the law of

\begin{enumerate}
\item[\textsuperscript{600}] Ibid.
\item[\textsuperscript{601}] [1989] 1 Lloyd's Rep. at p.572.
\item[\textsuperscript{602}] Ibid at p. 580.
\item[\textsuperscript{603}] [1982] 2 Lloyd's Rep. 304
\item[\textsuperscript{604}] In \textit{Broken Hill Proprietary Company Ltd v. Theodore Xenakis}, ibid., Bingham J. decided that the rule of applicable law on counter letters of guarantee should not be affected by the principle of independence between the primary letter of guarantee and the counter letter of guarantee. He went on to refuse to apply Article 2(c) of the URDG which states that Guarantees by their nature are separate transactions from the contract(s) or tender conditions on which they may be based, and Guarantors are in no way concerned with or bound by such contracts...". The learned judge also said "I would not agree with that at all. I must say. The party who gives the performance bond is vitally concerned. I would say. in the counter-guarantee".
\item[\textsuperscript{605}] Ibid at p.136.
\end{enumerate}
China, as the place of business of the Chinese instructing bank, on the counter letter of guarantee. Their argument was rejected by Phillips L.J who said that:

"I do not accept that submission. In practice, in international banking transactions of this nature, the place of payment will either be expressly agreed or the creditor bank will specify that place in which it wishes to have an account credited with the monies due and the debtor will normally comply with such a request: see *Royal Bank of Scotland Plc v. Cassa di Risparmio della Provincia Lombard and Others*. Any attempt to formulate some general rules as to the contractual place of performance is unrealistic."

The case clearly indicates that the court applied the English common law principles in deciding the applicable law to the counter letter of guarantee. According to these principles, the court is required to apply the law of the country with which the counter letter of guarantee was most closely connected. In arriving at this conclusion the court considered the facts that the letters of guarantee were issued in Turkey to a Turkish beneficiary and were governed by Turkish law as factors that provided a close connection between the counter letter of guarantee and the Turkish system of law. As a result, it reached the decision that a close relevant connection between counter letters of guarantee and the issuing of the letter of guarantee existed, and accordingly

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607 Ibid at p. 136.

608 *Turkiye Is Bankasi v. Bank of China*, supra, at p.135 where Judge Phillips said that "In my judgment, the circular letter made it plain that the texts of counter-guarantees had been revised in the light of Turkish legislation. The clear import of the circular letter was the form of contract in each of the annexes would be governed by Turkish law. In referring to that letter and adopting from the appropriate annex the defendants, in my judgment, implicitly agreed with the plaintiffs that the counter-guarantees would be governed by Turkish law".
the counter letter of guarantee was found to be closely connected with the Turkish system of law.609

The decision of *Turkiye Is Bankasi v. Bank of China*.610 was also recently approved by the Court of Appeal in the case of *Wahda Bank v Arab Bank plc*.611 In this case Murray Clayton Limited (MCL) ("the sellers") made three contracts for the sale of air defence equipment to the Libyan Armed Services Directorate of Military Procurement ("the buyers"). Accordingly, the sellers were required to arrange for a performance and advance payment letters of guarantee to be issued by the Wahda Bank ("the plaintiffs"). Wahda Bank issued the required letters of guarantee and received counter-letters of guarantee from Arab Bank. The Directorate called the letters of guarantee but did not pay. Wahda Bank called the counter letters of guarantee but Arab Bank did not pay. MCL was in liquidation. Wahda Bank commenced proceedings against Arab Bank in the English Commercial Court and sought summary judgment. Arab Bank, *inter alia*, sought leave to defend on the basis that the Libyan law applied to the counter letters of guarantee and that there were a number of defences available to Arab Bank under Libyan law. The court was asked to decide whether English law or Libyan law applied to the counter letters of guarantee in the absence of an express choice of law by the parties.

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The Court of Appeal held that the counter letters of guarantee were closely connected with the letters of guarantee. Staughton L.J. said:

"A banker who issues a performance bond for a tiny commission will want to ensure that he takes no greater risk than the solvency of the bank putting up his counter-guarantee. He will want to ensure that his right of reimbursement is back-to-back the same as his liability; and a banker who instructs another bank to issue a performance bond ought to, and in view would, readily agree to that." 612

In the absence of any express choice of law Staughton L.J. inferred without any doubt that the parties intended the counter letters of guarantee to be governed by the same law as governed the letters of guarantee. 613

It is to be noticed that the decision of Staughton L.J. in the Wahda Bank proves an inconsistency in the English courts approach in dealing with the problem of the applicable law in case of counter-letters of guarantee. Such inconsistency is shown in the change in Staughton L.J.'s view from the one he had previously taken in Attock Cement Ltd v Romanian Bank For Foreign Trade. 614 In Attock Cement, Staughton LJ decided that contractual relationships under a letter of credit contract are totally independent and, accordingly, rejected any connection between the letter of credit and the underlying contract with regard to the applicable law. 615 Although it was set aside by the judge, in Wahda Bank it is clear that he took a different stance.

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612 Ibid at p. 473.

613 Ibid.

614 [1989] 1 All ER 1189, [1989] 1 W.L.R 1147 at 1158

615 Ibid at 1158 where the Judge said "The Court of Appeal in Attock, of which I was a member, decided that where there is a letter of credit issued in connection with a commercial transaction the letter of credit is not, or at any rate not necessarily, infected with the proper law of the commercial contract."
from what was decided in Attock Cement case. On this point, it was said by the judge that:

"I do not for one moment resile, even if I could, from what was decided in the Attock case. But the present case is different."616

In the relationship between instructing and correspondent bank it is necessary to determine which bank's performance is characteristic of the contract between them. It is tentatively suggested that such performance is that of the correspondent bank since it is that bank's performance which is the essential feature of its contract with the instructing bank, namely the issuance of the primary guarantee and the execution thereof, whereas the first instructing bank is merely to pay charges and to indemnify the issuing/correspondent bank.617 Accordingly the applicable law will be presumptively that of the country in which the place of business of the bank (or branch thereof) at which the demand for payment is to be made.

Without a doubt, the decisions of the English courts in Turkiye Is Bankasi v. Bank of China618 and Wahda Bank v. Arab Bank plc.619 contradict the governing law rules as provided by the URDG and Uncitral Convention. Whereas, in the above cases the court observed that counter-letters of guarantee and primary letters of guarantee were intimately connected because the issue of the primary letter of guarantee provided the consideration for the

616 Ibid. at p.1158.

617 See Bertrams R.: Bank Guarantees in international Trade: supra, at p.351


counter-letter of guarantee, and that the counter-letter of guarantee was, therefore, governed by the law applicable to the primary guarantee.

As far as the URDG and the Uncitral Convention are concerned, the counter-letter of guarantee is governed by the law of the country where the instructing bank has its place of business. Art (27) of the URDG provides: "Unless otherwise provided in the Guarantee or Counter-Guarantee, its governing law shall be that of the place of business of the Guarantor or Instructing Party (as the case may be), or, if the Guarantor or Instructing Party has more than one place of business, that of the branch that issued the Guarantee or Counter-Guarantee." On the other hand, Art.(21) of the Uncitral Convention provides: "The undertaking is governed by the law the choice of which is: (a) Stipulated in the undertaking or demonstrated by the terms and conditions of the undertaking; or (b) Agreed elsewhere by the guarantor/issuer and the beneficiary." To determine the applicable law, Art. (22) of the Uncitral Convention provides: "Failing a choice of law in accordance with article 21, the undertaking is governed by the law of the State where the guarantor/issuer has that place of business at which the undertaking was issued".

It goes without saying that if any of these rules is incorporated in the counter letter of guarantee the general rule of deciding the applicable law still prevails. The rules respect the parties' freedom of choice subject to any mandatory rules or rules of public policy of the country before whose courts the dispute is brought.620 In the absence of an express choice of law, the rules.

620 Goode R., Guide to the ICC Uniform Rules for Demand Guarantees, supra, at p.115; see also art. (27) of the URDG and art.(21) of the Uncitral Convention which provides: "The undertaking is governed by the law the choice of which is:
(a) Stipulated in the undertaking or demonstrated by the terms and conditions of the undertaking; or
(b) Agreed elsewhere by the guarantor/issuer and the beneficiary.".
provide that the counter letter of guarantee is governed by the law of country where the issuing bank has its place of business and if the bank has more than one place of business, the governing law is that of the country in which the branch issuing the counter letter of guarantee is situated.621

The incorporation of the ICC Uniform Rules may raise the question of whether or not these rules may be taken as an express choice of law. It is suggested that cases involving conflict of laws will rarely occur in letters of guarantee transactions.622 This is because banks in most countries of the world operate letters of guarantee under both Uniform Rules for Contract Guarantees and Uniform Rules for Demand Guarantees of the International Chamber of Commerce. The uniformity that has been achieved through these rules most probably accounts for the minimal conflict of law litigation in letters of guarantee. Whether the action is brought in New York or Paris, one would expect the results to be the same. But this would perhaps be an over simplification of the position. The fact that the Uniform rules are published in several languages, including English, French, German and Arabic, may lead to different translations and therefore not quite the exact meaning of the original may be ascribed to the translation. There are also procedural rules in each country that have to be contended with, especially on the rules relating to evidence. What can and cannot be given in evidence and how the evidence is to be given, may all affect the outcome of the case. On the determination of

621 Art.27 of the URDG provides that: "Unless otherwise provided in the Guarantee or Counter-Guarantee, its governing law shall be that of the place of business of the Guarantor or Instructing Party (as the case may be), or, if the Guarantor or Instructing Party has more than one place of business, that of the branch that issued the Guarantee or Counter-Guarantee". While art.22 of the Uncitral Convention provides: "Failing a choice of law in accordance with article 21, the undertaking is governed by the law of the State where the guarantor/issuer has that place of business at which the undertaking was issued."

622 Jack R., Documentary Credits, supra, at p.295
the proper law of the letter of guarantee, the basis of the decision will differ from country to country, in the absence of an international convention. So that what one country may select as the proper law of the transaction may not be the same as another. Differences of interpretation of the ICC Rules may, therefore, arise depending on which courts of what country is having jurisdiction.623

In this light, it seems that there is a need for greater awareness for conflict of laws issues in general. It is essential to any dispute process that its method of operation be certain. Lack of certainty undermines respect for the system, and may cause inefficiency in the affairs being regulated. As seen above, the application of choice of law rules to letters of guarantee involves uncertainty as to the rules to be applied and the relevant transaction. It is submitted that the legal system whose courts will, in case of litigation, apply the rules to the letter of guarantee should be clear-cut from the time of contracting, rather than leaving them to be determined by the existing rules of choice of the forum. This normally entails a choice of law; but where this is not the case, the law applicable should also be specified at the earliest possible time.

Conclusion.

A bank's obligation to pay under letters of guarantee is the fundamental raison d'etre of this important commercial instrument. In this thesis an effort has been made to emphasise the significance of such an obligation and to analyse a number of legal issues that are associated with this important obligation in English law and under the Uniform Rules of the International Chamber of Commerce which aim to regulate the operation of letters of guarantee.

It has been shown that letters of guarantee are of recent origin. As a result of this, the rules of law governing them are not codified by statute under English law.

Obviously terminological inconsistency in referring to these instruments has caused a number of serious problems to banks by giving an inaccurate impression of the nature of their obligation to pay under letters of guarantee. Many of the terms that are currently in use by banks and parties to the letters of guarantee transactions have led to confusion in courts. Such confusion can be demonstrated in reviewing court decisions where the bank's obligation to pay under letters of guarantee has been considered as a secondary rather than a primary obligation to pay. As a solution to the problem of terminological inconsistency the term "letter of guarantee" has been suggested as preferable to others in common usage. In addition to the previously discussed advantages, it is believed that using this term would be acceptable in the international commercial community on the analogy of that well-known international commercial instrument, the letter of credit, as it comprehensively includes all types of letters of guarantee.
It has been shown that standby letters of credit operate in the same manner as letters of guarantee. They have been extensively used in the United States by American banks because of the limited powers of these banks under the National Bank Act to issue guarantees. Like letters of guarantee, standby letters of credit are used where there has been a total or partial failure of performance. Usually a simple note of demand signed by the beneficiary suffices for purposes of payment thereon. It has been noted that despite the similarities between the two instruments they are regulated by a different set of rules.

In practice, many banks wish their obligations to be subject to the widely accepted Uniform Customs and Practices for Documentary Credits (UCP) issued by the International Chamber of Commerce. It is a matter of debate whether such standby letters of credit are covered by the ICC Uniform Customs and Practices for Documentary Credits, since these deal with the standard type of letter of credit which presumes that payment should be effected upon execution by the beneficiary of the underlying contract, this execution being proven by presentation of the bill of lading and other documents. The standby letter of credit is quite the reverse, since it supposes non-execution by the account party of its contract obligations.

It would seem desirable therefore that, since in substance standby letters of credit perform the same role as letters of guarantee, they be covered by the same rules. It is recommended in this thesis that standby letters of credit be issued with reference to the ICC Uniform Rules of Demand Guarantees (URDG) rather than with reference to the ICC Uniform Customs and Practice for Documentary Credits (UCP).624 The United Nations

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Commission on International Trade Law (UNCITRAL) Convention on Independent guarantees and standby letters of credit (Uncitral Convention) is also believed to be a step in the right direction.

The paramount characteristic of the bank's obligation to pay under letters of guarantee is the principle of independence. The payment obligations of the bank and the beneficiary's right to payment are to be determined by reference to the terms and conditions as stated in the letter of guarantee and not by reference to the underlying relationship. Accordingly, the bank must pay if the terms of the letter of guarantee have been met and it cannot raise defences which emanate from the underlying relationship.

However, the principle of independence raises the question of the extent to which the bank's obligation to pay might be affected by relationships other than those arising from the underlying contract, considering that most of letters of guarantee normally exist as a requirement of the underlying contract. It has been argued that the principle of independence should not be interpreted to mean that the bank is prohibited under all circumstances from inquiring into the underlying relationship of the parties. Accordingly, the bank should not be considered as violating the principle of independence if it refers to the underlying relationship of the parties so as to ensure whether or not the beneficiary's demand, for example, relates to the proper underlying contract that is secured by the letter of guarantee. Again, the strict interpretation of the principle of independence should not prohibit the bank from referring to the underlying contract in order to check the authority of the person who is making the demand under the letter of guarantee. The need for the bank's inquiry into the underlying relationship also appears to be more pressing in
the case of documentary letters of guarantee, where the bank is obliged to examine the demand and the documents that are presented with the demand.

It has also been concluded that the bank's obligation to pay under the letter of guarantee should not always construed to be absolute. The nature of the bank's obligation may be decided in accordance with many factors such as the wording of the letter of guarantee, the mechanism of payment and the limits of the bank's authority to inquire into the underlying contract. It is accordingly wrong to consider the bank's obligation to pay as being always absolute solely for the sake of consistency in the courts' decisions with regard to the letter of guarantee.

It has been also recommended that the letter of guarantee should set forth an acceptable form of demand according to which the bank's obligation to pay is triggered. This is normally determined by the type, terms and conditions of the letter of guarantee. This would play a very important role in reducing the disputes that often occur in the event of a misinterpretation of the payment mechanism in the bank's obligation to pay.

If the letter of guarantee is issued subject to the URDG, the bank is required to examine the demand and the accompanying documents within a reasonable time before it fulfills its duty of payment under the letter of guarantee.625 The term "reasonable time" is vague and obscure and can lead to protracted procedures without any restrictions or limitations on the bank's side, which undoubtedly conflicts with the purpose of the letter of guarantee as being a prompt way of payment by the bank.626 It is therefore

625 See Art. 10(a) of the URDG.
recommended that the bank's liberty in relation to the time needed for examination should be restricted. Accordingly, a similar provision of Art.13(b) of the UCP and Art. 16(2) of the Uncitral Convention which limits the time of examination as not exceeding seven banking days following the day of the receipt of documents, is recommended in any future revision Uniform Rules with regard to letters of guarantee.

When it issues a letter of guarantee the bank should always set out clearly the date on or event subject to which the letter of guarantee expires. Every letter of guarantee should specify a final date by which the demand for payment must be received by the bank. Letters of guarantee that include no specific expiry date are problematic. They put the bank under a continuous obligation to pay. The English banks should also note that, when they issue letters of guarantee to beneficiaries in other countries, according to the jurisdiction of these countries the letters of guarantee may continue to be valid despite the date of expiry, provided the letter of guarantee has not been returned by the beneficiary. The banks therefore are strongly advised to take this fact into consideration and to make sure that the wording of the letter of guarantee explicitly provides for the termination of its obligation to pay upon the expiry date as mentioned in the letter of guarantee, whether the letter of guarantee document has been returned by the beneficiary to the bank or not.

It has also been shown that in banking practice the beneficiary may sometimes endeavour to put pressure on the account party in order to carry out duties in addition to those agreed upon in the underlying contract, or to keep the letter of guarantee valid as long as possible by resorting to what is

627 See Art 3 of the URCG which takes the approach that letters of guarantee without a date of expiry are considered as valid for an unlimited period of time.

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commonly known as the "extend or pay" practice. The bank in this case should not be affected by the threats of the beneficiary in paying or extending the letter of guarantee. Although it is not obliged to do so, the bank should consult its customer on how to respond to the beneficiary's "pay or extend" request before it can take the proper decision. In this regard, the bank is required to use its discretionary power in order to decide whether or not the account party has replied within a specified time. If it is decided that the account party has not answered within that time, the bank has the choice of either paying or extending the letter of guarantee. It can use its implied authority to extend the duration of the letter of guarantee in order to avoid payment which could be considered a solution in favour of the account party. However in the light of these difficulties it is suggested that the bank should insert a clause which gives it the authority to respond, without needing to the account party's consent, to a demand for extension in circumstances where it finds necessary to do so.

This thesis has also discussed the rule that fraud under a letter of guarantee transaction constitutes an exception to the bank's obligation to pay upon the beneficiary's demand. Banks are always placed in a critical position when fraud is claimed by the account party. They try to maintain the balance between their relationship with customers, and honouring their obligation to pay under letters of guarantee.

Fraud is a word that has been seen to be interpreted differently by commentators and courts and to attract diversity of opinion on the degree necessary to deprive the beneficiary from payment. There is further

628 Penn G., "On-demand Bonds Primary or Secondary Obligations?", supra, at p.228.
disagreement on the "location" of fraud and whether fraud of a third party should also disentitle the beneficiary from payment. Reviewing the position in the light of English and American jurisdictions has shown a major distinguishing point. There has been no English case finding a demand for payment to be fraudulent, mainly because the "clear fraud" standard has been difficult to achieve.

The rationale underlying the fraud exception does not contradict the rule of independence of the letter of guarantee from the underlying transaction, nor does it conflict with the practical demands of international commerce. The difficulty however lies in the application of the exception in accordance with the justifications underlying the standard. Some American Courts have taken a relaxed approach to the application of the fraud exception. A preliminary injunction restraining the issuing banker from effecting payment can be obtained on a mere allegation of fraud, followed by a further hearing as to the actual merits of the case. This relaxed approach to fraud would appear to encompass situations of politically stimulated demands under standby letters of credit transactions. On the other hand, English courts have taken a restrictive approach to the fraud exception, so that the plaintiff must show an established fraud before obtaining an interlocutory relief. It has been argued that a relaxed approach as to the standard of proof required in an allegation of fraud in letters of guarantee transactions might undermine the utility of the device. A broad interpretation of the standard of fraud would undermine the rule of letter of guarantee independence.

It may therefore be concluded that despite the recent decisions of English courts regarding letters of guarantee, which undoubtedly have contributed to the development of English law relating to fraud, it seems that
this area is still vague and obscure \(^{630}\) and that little attention has been paid to the analysis of the fraud concept in this context.\(^ {631}\) So far, no clear definition of what may constitute fraud in this context has been given by the courts. English courts have taken the view that where a clear fraud has been established, the bank should not pay the beneficiary. The difficulties associated with the establishment of a 'clear fraud' were discussed in this thesis. It is suggested that any future revision of the Uniform Rules by the International Chamber of Commerce should contain provisions on fraud as an exception to the doctrine of the independent existence of the letter of guarantee contract from the underlying contracts. Such an exception would provide some guidance on what constitutes fraud and the effect thereof. It is unsatisfactory that an area of law so important and pervasive in letters of guarantee should be left to the vagaries of national laws. The ICC rules should also make it clear who has what rights and duties whenever an allegation of fraud is raised.

It has been also indicated that the injunction is a useful remedy in preventing the abuse of letters of guarantee. It contributes to the growth of letters of guarantee law in two ways. First, it prohibits users from engaging in certain actions like fraud. Secondly, it assures the users (mainly applicants) that their interests will be protected by the courts. In letter of guarantee practice, the injunction has been a useful device to prevent a bank from paying a defrauding beneficiary. Recent developments also indicate that it can be used to prevent the beneficiary from presenting documents to the bank in

\(^{630}\) Jack R., Documentary Credits, supra. at p.189.

\(^{631}\) An example of the English courts' attempts to set out a definition on the elements of fraud in the common law could be concluded by the ruling of Parker J in GKN Contractors LTD v Lloyds Bank plc[1985] 30 B.L.R 48 where he said that "fraud" could be committed by the beneficiary when he presents a claim which he knows at the time to be invalid claim".
order to demand payment. It has been argued that in the latter circumstances, courts should require strict proof of fraud in the formation of the underlying contract. The move to enjoin the beneficiary started in England where the requirement that one proves "clear fraud" imposes an exceptionally high standard. It therefore appears that the virtual non-availability of an injunction against an issuing bank is closely associated with attempting the alternative of enjoining the beneficiary.

The circumstances under which injunctions are issued should be restricted. Too many injunctions would destroy the usefulness of letters of guarantee and increase costs for everyone. The Courts should always consider the likely impact of a decision to grant an injunction on letters of guarantee practice. A careful balance must be struck, as denying injunctions completely may lead to the raising of prices to provide a cushion against the risk arising from unfair calling of letters of guarantee.

The bank's obligation to pay under letters of guarantee should not be affected by the amount of damages suffered by the beneficiary. Accordingly, the true amount of damages sustained by the beneficiary as a result of the account party's default must be beyond the bank's concerns. The bank should pay as long as it receives a demand which conforms to the terms and the conditions of the letter of guarantee. The English courts believed that this would undermine the certainty of payment that makes letters of guarantee so appealing to persons engaged in commerce and would also undermine the commercial utility of these instruments. Moreover, permitting or requiring an issuing bank to inquire into an underlying contractual dispute would also place the bank, which has much less information concerning the underlying contract than do either the beneficiary or the account party, in the position of analysing the contract documents. This would be, from a policy standpoint, an
inefficient division of responsibilities in a contractual dispute that ideally should be resolved between the two parties to the contract.

Under an indirect letter of guarantee, the instructing bank recognises that using the services of the correspondent bank can lead the instructing bank into serious difficulties with consequential liability. To avoid such difficulties the instructing bank in practice relies on certain clauses that aim to limit its liabilities and responsibilities under the letter of guarantee.

It is has become very common in the banking practice for the banks to insert a number of exemption clauses in their agreements with the customers, by which they exempt themselves from different kinds of liabilities which might result from their obligation to pay under the letter of guarantee. The common use of exemption clauses has raised some legal issues such as the legal grounds for the insertion of such clauses and the extent to which banks can rely on these clauses to secure exemption from liability. It has been emphasised that the bank should not be absolved from liability through relying on these exempting clauses for the acts or the omissions that result from its own negligence.

As far as choice of law is concerned, it has been noted that some of the letters of guarantee specify the law that governs them. In the absence of such specification, the decision is normally made by the courts if there is litigation.

It has been seen that both courts and banks favour the law of the place of payment as the applicable law. The issue of the applicable law has proved to be more problematical in the case of absence of choice of law clause in the counter-letter of guarantee and in the light of the principle of independence between the contractual relationship under the letter of guarantee. An inconsistency has been shown in the English courts' approach in dealing with the problem of the applicable law in case of counter-letters of guarantee. On
the one hand, the choice of law clause in the letter of guarantee is accepted by the courts as applicable to the counter letter of guarantee. On the other hand, the application of the choice of law clause of the letter of guarantee to the counter letter of guarantee has been refused by some of the English courts on the ground of the principle of independence between the two instruments. As far as the URDG and the Uncitral Convention are concerned, the counter letter of guarantee is governed by the law of the country where the instructing bank has its place of business. It has been suggested that a clearer approach should be taken by the English courts towards this issue. Therefore the URDG approach which applies the law of country of the bank's place of business is recommended as it conforms with the principle of "characteristic performance" as provided by the Contracts (Applicable Law) Act 1990 and also does not violate the principle of independence under the letters of guarantee.

It is suggested that the precise nature of the revision or extensions that would be required to the Uniform Rules by the Chamber of Commerce is to provide the indicated solutions to the problems outlines in this thesis would require careful consideration to avoid creating unexpected and additional problems. The available options could form the basis of the work of some future researchers in the allied fields of English law and the Uniform Rules.
APPENDIX A

Uniform Rules for Contract Guarantee
ICC Publication No. 325

A. Scope

Article 1

1. These Rules apply to any guarantee, bond, indemnity, surety or similar undertaking, however named or described ("guarantee"), which states that it is subject to the Uniform Rules for Tender, Performance and Repayment Guarantees ("Contract Guarantees") of the International Chamber of Commerce (Publication No. 325) and are binding upon all parties thereto unless otherwise expressly stated in the guarantee or any amendment thereto.

2. Where any these Rules is contrary to a provision of the law applicable to the guarantee from which the parties cannot derogate, that provision prevails.

B. Definition

Article 2

For the purpose of these Rules:

a. "tender guarantee" means an undertaking given by a bank, insurance company or other party ("the guarantor") at the request of a tender ("the principal") or given on the instructions of a bank, insurance company, or other party so requested by the principal ("the instructing party") to a party inviting tenders ("the beneficiary") whereby the guarantor undertakes in the event of default by the principal in the obligations resulting from the submission of the tender-to make payment to the beneficiary within the limits of a stated sum of money;

b. "performance guarantee" means an undertaking given by a bank, insurance company or other party ("the guarantor") at the request of a supplier of goods or services or other contractor ("the principal") or given on the instructions of
a bank, insurance company, or other party so requested by the principal ("the instructing party") to a buyer or to an employer ("the beneficiary") whereby the guarantor undertakes-in the event of default by the principal in due performance of the terms of a contract between the principal and the beneficiary ("the contract")-to make payment to the beneficiary within the limits of a stated sum of money or, if the guarantee so provides, at the guarantor's option, to arrange for performance of the contract;

c. "repayment guarantee" means an undertaking given by a bank, insurance company or other party ("the guarantor") at the request of a supplier of goods or services or other contractor ("the principal") or given on the instructions of a bank, insurance company or other party so requested by the principal ("the instructing party") to a buyer or to an employer ("the beneficiary") whereby the guarantor undertakes-in the event of default by the principal to repay in accordance with the terms and conditions of a contract between the principal and the beneficiary ("the contract") any sum or sums advanced or paid by the beneficiary to the principal and not otherwise repaid-to make payment to the beneficiary within the limits of a stated sum of money.

C. Liability of the guarantor to the beneficiary

Article 3

1. The guarantor is liable to the beneficiary only in accordance with the terms and conditions specified in the guarantee and these Rules and up to an amount not exceeding that stated in the guarantee.

2. The amount of liability stated in the guarantee shall not be reduced by reason of any partial performance of the contract, unless so specified in the guarantee.

3. The guarantor may rely only on those defences which are based on the terms and conditions specified in the guarantee or are allowed under these Rules.
D. Last date for claim

Article 4

If a guarantee does not specify a last date by which a claim must have been received by the guarantor, such last date ("expiry date") is deemed to be:

a. in the case of a tender guarantee, six months from the date of the guarantee;

b. in the case of a performance guarantee, six months from the date specified in the contract for delivery or completion or any extension thereof, or one month after expiry of any maintenance period (guarantee period) provided is expressly covered by the performance guarantee.

c. in the case of a repayment guarantee, six months from the date specified in the contract for delivery or completion or any extension thereof.

If the expiry date fails on a non-business day, the expiry dated is extended until the first following business day.

E. Expiry of guarantee

Article 5

1. If no claim has been received by the guarantor on or before the expiry date or if any claim arising under the guarantee has been settled in full satisfaction of all the rights of the beneficiary thereunder, the guarantee ceases to be valid.

2. Notwithstanding the provisions of Article 4, in the case of tender guarantees:

a. upon acceptance by the beneficiary of the tender by the award of the contract to the principal and, if so provided for in the written contract, or if no contract has been signed and it is so provided for in the tender, the production by the principal of a performance guarantee or, if no such guarantee is required, the tender guarantee issued on his behalf ceases to be valid;
b. a tender guarantee also ceases to be valid if and where the contract to which it relates is awarded to another tenderer, whether or not that tenderer meets the requirements referred to in para 2(a) of this Article;

c. a tender guarantees also ceases to be valid in the event of the beneficiary expressly declaring that he does not intend to place a contract.

**F. Return of guarantee**

*Article 6*

When a guarantee has ceased to be valid in accordance with its own terms and conditions or with these Rules, retention of the document embodying the guarantee does not in itself confer any rights upon the beneficiary, and the document should be returned to the guarantor without delay.

**G. Amendments to contracts and guarantees**

*Article 7*

1. A tender guarantee is valid only in respect of the original tender submitted by the principal and does not apply in the case of any amendment thereto, nor is it valid beyond the expiry date specified in the guarantee or provided for these Rules, unless the guarantor has given notice in writing or by cable or telegram or telex to the beneficiary that the guarantee so applies or that the expiry date has been extended.

2. A performance guarantee or a repayment guarantee may stipulate that it shall not be valid in respect of any amendment to the contract, or that the guarantor be notified of any such amendment for his approval. Failing such a stipulation, the guarantee is valid in respect of the obligations of the principal as expressed in the contract and any amendment thereto. However, the guarantee shall not be valid in excess of the amount or beyond the expiry date specified in the guarantee or provided for by these Rules, unless the guarantor has given notice in writing or by cable or telegram or telex to the beneficiary that the amount has been increased to a stated figure or that the expiry date has been extended.
3. Any amendment made by the guarantor in the terms and conditions of the guarantee shall be effective in respect of the beneficiary only if agreed to by the beneficiary and in respect of the principal or the instructing party, as the case may be, only if agreed to by the principal or the instructing party, as the case may be.

**H. Submission of claim**

**Article 8**

1. A claim under a guarantee shall be made in writing or by cable or telegram or telex to be received by the guarantor not later than on the expiry date specified in the guarantee or provided for by these Rules.

2. On receipt of a claim the guarantor shall notify the principal or the instructing party, as the case may be, without delay, of such claim and of any documentation received.

3. A claim shall not be honoured unless

   a. it has been made and received as required by para. 1 of this Article; and
   b. it is supported by such documentation as is specified in the guarantee or in these Rules; and
   c. such documentation is presented within the period of time after the receipt of a claim specified in the guarantee, or, failing such a specification, as soon as practicable, or, in the case of documentation of the beneficiary himself, at the latest within six months from the receipt of a claim.

   In any event, a claim shall not be honoured if the guarantee has ceased to be valid in accordance with its own terms or with these Rules.

**I. Documentation to support claim**

**Article 9**

If a guarantee does not specify the documentation to be produced in support of a claim by the beneficiary, the beneficiary must submit:
a. in the case of tender guarantee, his declaration that the principal's tender has been accepted and that the principal has then either failed to sign the contract or has failed to submit a performance guarantee as provided for in the tender, and his declaration of agreement, addressed to the principal, to have any dispute on any claim by the principal for payment to him by the beneficiary of all or part of the amount paid under the guarantee settled by a judicial or arbitral tribunal as specified in the tender documents or, if not so specified or otherwise agreed upon, by arbitration in accordance with the Rules of the ICC Court of Arbitration or with the UNCITRAL Arbitration Rules, at the option of the principal;

b. in the case of a performance guarantee or of a repayment guarantee, either a court decision or an arbitral award justifying the claim, or the approval of the principal in writing to the claim and the amount to be paid.

**J. Applicable law**

**Article 10**

If a guarantee does not indicate the law by which it is to be governed, the applicable law is that of the guarantor's place of business. If the guarantor has more than one place of business, the applicable law is that of the branch which is issued the guarantee.

**K. Settlement of disputes**

**Article 11**

1. Any disputes arising in connection with the guarantee may be referred to arbitration by agreement between the guarantor and the beneficiary, either in accordance with the Rules of the ICC Court of Arbitration, the UNCITRAL Arbitration as may be agreed between the guarantor and the beneficiary.

2. If a dispute between the guarantor and the beneficiary which touches upon the rights and obligations of the principal or the instructing party is referred to arbitration, the principal or the instructing party shall have the right to intervene in such arbitral proceedings.
3. If the guarantor and the beneficiary have not agreed to arbitration or to the jurisdiction of any specific court, any dispute between them relating to the guarantee shall be settled exclusively by the competent court of the country of the guarantor's place of business or, if the guarantor has more than one place of business, by the competent court of the country of his main place of business or, at the option of the beneficiary, by the competent court of the country of the branch which issued the guarantee.
APPENDIX B

ICC Uniform Rules for Demand Guarantees

A. SCOPE AND APPLICATION OF THE RULES

Article 1

These Rules apply to any demand guarantee and amendment thereto which a Guarantor (as hereinafter described) has been instructed to issue and which states that it is subject to the Uniform Rules for Demand Guarantees of the International Chamber of Commerce (Publication No. 458) and are binding on all parties thereto except as otherwise expressly stated in the Guarantee or any amendment thereto.

B. DEFINITIONS AND GENERAL PROVISIONS

Article 2

a. For the purpose of these Rules, a demand guarantee (hereinafter referred to as "Guarantee") means any guarantee, bond or other payment undertaking, however named or described, by a bank, insurance company or other body or person (hereinafter called "the Guarantor") given in writing for the payment of money on presentation in conformity with the terms of the undertaking of a written demand for payment and such other document(s) (for example, a certificate by an architect or engineer, a judgment or an arbitral award) as may be specified in the Guarantee, such undertaking being given:

i) at the request or on the instructions and under the liability of a party (hereinafter called "the Principal"); or

ii) at the request or on the instructions and under the liability of a bank, insurance company or any other body or person (hereinafter "the Instructing Party") acting on the instructions of a Principal to another party (hereinafter the "Beneficiary").

b) Guarantees by their nature are separate transactions from the contract(s) or tender conditions on which they may be based, and Guarantors are in no way
concerned with or bound by such contract(s), or tender conditions, despite the inclusion of a reference to them in the Guarantee. The duty of a Guarantor under a Guarantee is to pay the sum or sums therein stated on the presentation of a written demand for payment and other documents specified in the Guarantee which appear on their face to be in accordance with the terms of the Guarantee.

c) For the purpose of these Rules, "Counter-Guarantee" means any guarantee, bond or other payment undertaking of the Instructing Party, however named or described, given in writing for the payment of money to the Guarantor on presentation in conformity with the terms of the undertaking of a written demand for payment and other documents specified in the Counter-Guarantee which appear on their face to be in accordance with the terms of the Counter-Guarantee. Counter-Guarantees are by their nature separate transactions from the Guarantees to which they relate and from any undertaking contract(s) or tender conditions, and Instructing Parties are in no way concerned with or bound by such Guarantees, contract(s) or tender conditions, despite the inclusion of a reference to them in the Counter-Guarantee.

d) The expressions "writing" and "written" shall include an authenticated teletransmission or tested electronic data interchange ("EDI") message equivalent thereto.

Article 3
All instructions for the issue of Guarantees and amendments thereto and Guarantees and amendments themselves should be clear and precise and should avoid excessive detail. Accordingly, all Guarantees should stipulate:

a) the Principal;
b) the Beneficiary;
c) the Guarantor;
d) the underlying transaction requiring the issue of the Guarantee;
e) the maximum amount payable and the currency in which it is payable;
f) the Expiry Date and/or Expiry Event of the Guarantee;
g) the terms for demanding payment;
h) any provision for reduction of the guarantee amount.
Article 4
The Beneficiary's right to make a demand under a Guarantee is not assignable unless expressly stated in the Guarantee or in an amendment thereto.

This Article shall not, however, affect the Beneficiary's right to assign any proceeds to which he may be, or may become, entitled the Guarantee.

Article 5
All Guarantees and Counter-Guarantees are irrevocable unless otherwise indicated.

Article 6
A Guarantee enters into effect as from the date of its issue unless its terms expressly provide that such entry into effect is to be at a later date or is to be subject to conditions specified in the Guarantee and determinable by the Guarantor on the basis of any documents therein specified.

Article 7
a) Where a Guarantor has been given instructions for the issue of a Guarantee but the instructions are such that, if they were to be carried out, the Guarantor would by reason of law or regulation in the country of issue be unable to fulfill the terms of the Guarantee, the instructions shall not be executed and the Guarantor shall immediately inform the party who gave the Guarantor his instructions by telecommunication, or, if that is not possible, by other expeditious means, of the reasons for such inability and request appropriate instructions from that party.

b) Nothing in this Article shall oblige the Guarantor to issue a Guarantee where the Guarantor has not agreed to do so.

Article 8
A Guarantee may contain express provision for reduction by a specified or determinable amount or amounts on a specified date or dates or upon
presentation to the Guarantor of the document(s) specified for this purpose in the Guarantee.

C. LIABILITIES AND RESPONSIBILITIES

Article 9
All documents specified and presented under a Guarantee, including the demand, shall be examined by the Guarantor with reasonable care to ascertain whether or not they appear on their face to conform with the terms of the Guarantee. Where such documents do not appear so to conform or appear on their face to be inconsistent with one another, they shall be refused.

Article 10
a) A Guarantor shall have a reasonable time within which to examine a demand under a Guarantee and to decide whether to pay or to refuse the demand.

b) If the Guarantor decides to refuse a demand, he shall immediately give notice thereof to the Beneficiary by teletransmission, or, if that is not possible, by other expeditious means. Any documents presented under the Guarantee shall be held at the disposal of the Beneficiary.

Article 11
Guarantors and Instructing Parties assume no liability or responsibility for the form, sufficiency, accuracy, genuineness, falsification, or legal effect of any document presented to them or for the general and/or particular statements made therein, nor for the good faith or acts or omissions of any person whomever.

Article 12
Guarantors and Instructing Parties assume no liability or responsibility for the consequences arising out of delay and/or loss in transit of any messages, letters, demands or documents, or for delay, mutilation or other errors arising in the transmission of any telecommunication. Guarantors and Instructing Parties assume no liability for errors in translation or interpretation of technical terms and reserve the right to transmit Guarantee texts or any parts thereof without translating them.
Article 13
Guarantors and Instructing Parties assume no liability or responsibility for consequences arising out of the interruption of their business by acts of God, riots, civil commotions, insurrections, wars or any other causes beyond their control or by strikes, lock-outs or industrial actions of whatever nature.

Article 14
a) Guarantors and Instructing Parties utilising the services of another party for the purpose of giving effect to the instructions of a Principal do so for the account and at the risk of that Principal.

b) Guarantors and Instructing Parties assume no liability or responsibility should instructions they transmit not be carried out even if they have themselves taken the initiative in the choice of such other party.

c) The Principal shall be liable to indemnify the Guarantor or the Instructing Party, as the case may be, against all obligations and responsibilities imposed by foreign laws and usages.

Article 15
Guarantors and Instructing Parties shall not be excluded from liability or responsibility under the terms of Articles 11, 12, and 14 above for their failure to act in good faith and with reasonable care.

Article 16
A Guarantor is liable to the Beneficiary only in accordance with the terms specified in the Guarantee and any amendment(s) thereto and in these Rules, and up to an amount not exceeding that stated in the Guarantee and any amendment(s) thereto.

D. DEMANDS
Article 17
Without prejudice to the terms of Article 10, in the event of a demand the Guarantor shall without delay so inform the principal or, where applicable, his
Instructing Party, and in that case the Instructing Party shall so inform the Principal.

**Article 18**
The amount payable under a Guarantee shall be reduced by the amount of any payment made by the Guarantor in satisfactions of a demand in respect thereof and, where the maximum amount payable under a Guarantee has been satisfied by payment and/or reduction, the Guarantee shall thereupon terminate whether or not the Guarantee and any amendment(s) thereto are returned.

**Article 19**
A demand shall be made in accordance with the terms of the Guarantee before its expiry, that is, on or before its Expiry Date and before any Expiry Event as defined in Article 22. In particular, all documents specified in the Guarantee for the purpose of the demand, and any statement required by Article 20, shall be presented to the Guarantor before its expiry at its place of issue; otherwise the demand shall be refused by the Guarantor.

**Article 20**
a) Any demand for payment under the Guarantee shall be in writing and shall (in addition to such other documents as may be specified in the Guarantee) be supported by a written statement (whether in the demand itself or in a separate document or documents accompanying the demand and referred to in it) stating:
   (i) that the Principal is in breach of his obligation(s) under the underlying contract(s) or, in the case of a tender guarantee, the tender conditions; and
   (ii) the respect in which the Principal is in breach.

b) Any demand under the Counter-Guarantee shall be supported by a written statement that the Guarantor has received a demand for payment under the Guarantee in accordance with its terms and with this Article.

c) Paragraph (a) of this Article applies except to the extent that it is expressly excluded by the terms of the Guarantee. Paragraph (b) of this Article applies except to the extent that it is expressly excluded by the terms of the Counter-Guarantee.
d) Nothing in this Article affects the application of Articles 2(b) and 2(c), 9 and 11.

Article 21
The Guarantor shall without delay transmit the Beneficiary's demand and any related documents to the Principal or, where applicable, to the Instructing Party for transmission to the Principal.

E. EXPIRY PROVISIONS

Article 22
Expiry of the time specified in a Guarantee for the presentation of demands shall be upon a specified calendar date ("Expiry Date") or upon presentation to the Guarantor of the document(s) specified for the purpose of expiry ("Expiry Event"). If both an Expiry Date and an Expiry Event are specified in a Guarantee, the Guarantee shall expire on whichever of the Expiry Date or Expiry Event occurs first, whether or not the Guarantee and any amendment(s) thereto are returned.

Article 23
Irrespective of any expiry provision contained therein, a Guarantee shall be canceled on presentation to the Guarantor of the Guarantee itself or the Beneficiary's written statement of release from liability under the Guarantee, whether or not, in the latter case, the Guarantee or any amendments thereto are returned.

Article 24
Where a Guarantee has terminated by payment, expiry, cancellation or otherwise, retention of the Guarantee or of any amendments thereto shall not preserve any rights of the Beneficiary under the Guarantee.

Article 25
Where to the knowledge of the Guarantor the Guarantee has terminated by payment, expiry, cancellation or otherwise, or there has been a reduction of the total amount payable thereunder, the Guarantor shall without delay so
notify the Principal or, where applicable, the Instructing Party and, in that case, the Instructing Party shall so notify the Principal.

**Article 26**

If the Beneficiary requests an extension of the validity of the Guarantee as an alternative to a demand for payment submitted in accordance with the terms and conditions of the Guarantee and these Rules, the Guarantor shall without delay so inform the party who gave the Guarantor his instructions. The Guarantor shall then suspend payment of the demand for such time as is reasonable to permit the Principal and the Beneficiary to reach agreement on the granting of such extension and for the Principal to arrange for such extension to be issued. Unless an extension is granted within the time provided by the preceding paragraph, the Guarantor is obliged to pay the Beneficiary's conforming demand without requiring any further action on the Beneficiary's part. The Guarantor shall incur no liability (for interest or otherwise) should any payment to the Beneficiary be delayed as a result of the above-mentioned procedure.

Even if the Principal agrees to or requests such extension, it shall not be granted unless the Guarantor and the Instructing Party or Parties also agree thereto.

**F. GOVERNING LAW AND JURISDICTION**

**Article 27**

Unless otherwise provided in the Guarantee or Counter-Guarantee, its governing law shall be that of the place of business of the Guarantor or Instructing Party (as the case may be), or, if the Guarantor or Instructing Party has more than one place of business, that of the branch that issued the Guarantee or Counter-Guarantee.

**Article 28**

Unless otherwise provided in the Guarantee or Counter-Guarantee, any dispute between the Guarantor and the Beneficiary relating to the Guarantee
or between the Instructing Party and the Guarantor relating to the Counter-Guarantee shall be settled exclusively by the competent court of the country of the place of business of the Guarantor or Instructing Party (as the case may be), or, if the Guarantor or Instructing Party has more than one place of business, by the competent court of the country of the branch which issued the Guarantee or Counter-Guarantee.
APPENDIX C

DRAFT UNITED NATIONS CONVENTION ON INDEPENDENT GUARANTEES AND STAND-BY LETTERS OF CREDIT

CHAPTER I. SCOPE OF APPLICATION

Article 1. Scope of application

(1) This Convention applies to an international undertaking referred to in article 2:

(a) If the place of business of the guarantor/issuer at which the undertaking is issued is in a Contracting State, or

(b) If the rules of private international law lead to the application of the law of a Contracting State,

unless the undertaking excludes the application of the Convention.

(2) This Convention applies also to an international letter of credit not falling within article 2 if it expressly states that it is subject to this Convention.

(3) The provisions of article 21 and 22 apply to international undertakings referred to in article 2 independently of paragraph (1) of this article.

Article 2. Undertaking

(1) For the purposes of this Convention, an undertaking is an independent commitment, known in international practice as an independent guarantee or as a stand-by letter of credit, given by a bank or other institution or person ("guarantor/issuer") to pay to the beneficiary a certain or determinable amount upon simple demand or upon demand accompanied by other documents, in conformity with the terms and any documentary conditions of the undertaking, indicating, or from which it is to be inferred, that payment is due
because of a default in the performance of an obligation, or because of another contingency, or for money borrowed or advanced, or on account of any mature indebtedness undertaken by the principal/applicant or another person.

(2) The undertaking may be given:

(a) At the request or on the instruction of the customer ("principal/applicant") of the guarantor/issuer;

(b) On the instructions of another bank, institution or person ("instructing party") that acts at the request of customer ("principal/applicant") of that instructing party; or

(c) On behalf of the guarantor/issuer itself.

(3) Payment may be stipulated in the undertaking to be made in any form, including:

(a) Payment in a specified currency or unit of account;

(b) Acceptance of a bill of exchange (draft);

(c) Payment on a deferred basis;

(d) Supply of a specified item of value.

(4) The undertaking may stipulate that the guarantor/issuer itself is the beneficiary when acting in favour of another person.

Article 3. Independence of undertaking

For the purposes of this Convention, an undertaking is independent where the guarantor/issuer's obligation to the beneficiary is not:
(a) Dependent upon the existence or validity of underlying transaction, or upon any other undertaking (including stand-by letters of credit or independent guarantees to which confirmations or counter-guarantees relate); or

(b) Subject to any term or condition not appearing in the undertaking, or to any future, uncertain act or event except presentation of documents or another such act or event within a guarantor/issuer's sphere of operations.

**Article 4. Internationality of undertaking**

(1) An undertaking is international if the places of business, as specified in the undertaking, of any two of the following persons are in different States: guarantor/issuer, beneficiary, principal/applicant, instructing party, confirmer.

(2) For the purposes of the preceding paragraph:

(a) If the undertaking lists more than one place of business for a given person, the relevant place of business is that which has the closest relationship to the undertaking;

(b) If the undertaking does not specify a place of business for a given person but specifies its habitual residence, that residence is relevant for determining the international character of the undertaking.

**CHAPTER II. INTERPRETATION**

**Article 5. Principles of interpretation**

In the interpretation of this Convention, regard is to be had to its international character and to the need to promote uniformity in its application and the observance of good faith in the international practice of independent guarantees and stand-by letters of credit.
Article 6. Definitions

For the purposes of this Convention and unless otherwise indicated in a provision of this Convention or required by the context:

(a) "Undertaking" includes "counter-guarantee" and "confirmation of an undertaking";

(b) "Guarantor/issuer" includes "counter-guarantor" and "confirmer";

(c) "Counter-guarantee" means an undertaking given to the guarantor/issuer of another undertaking by its instructing party and providing for payment upon simple demand or upon demand accompanied by other documents, in conformity with the terms and any documentary conditions of the undertaking, indicating, or from which it is to be inferred, that payment under that other undertaking has been demanded from, or made by, the person issuing that other undertaking;

(d) "Counter-guarantor" means the person issuing a counter-guarantee;

(e) "Confirmation" of an undertaking means an undertaking added to that of the guarantor/issuer, and authorized by the guarantor/issuer, providing the beneficiary with the option of demanding payment from the confirmer instead of from the guarantor/issuer, upon simple demand or upon demand accompanied by other documents, in conformity with the terms and any documentary conditions of the confirmed undertaking, without prejudice to the beneficiary's right to demand payment from the guarantor/issuer;

(f) "Confirmer" means the person adding a confirmation to an undertaking;

(g) "Document" means a communication made in a form that provides a complete record thereof.
CHAPTER III.
FORM AND CONTENT OF UNDERTAKING

Article 7. Issuance, form and irrevocability of undertaking

(1) Issuance of an undertaking occurs when and where the undertaking leaves the sphere of control of the guarantor/issuer concerned.

(2) An undertaking may be issued in any form which preserves a complete record of the text of the undertaking and provides authentication of its source by generally accepted means or by a procedure agreed upon by the guarantor/issuer and the beneficiary.

(3) From the time of issuance of an undertaking, a demand for payment may be made in accordance with the terms and conditions of the undertaking, unless the undertaking stipulates a different time.

(4) An undertaking is irrevocable upon issuance, unless it stipulates that it is revocable.

Article 8. Amendment

(1) An undertaking may not be amended except in the form stipulated in the undertaking or, failing such stipulation, in a form referred to in paragraph (2) of article 7.

(2) Unless otherwise stipulated in the undertaking or elsewhere agreed by the guarantor/issuer and the beneficiary, an undertaking is amended upon issuance of the amendment if the amendment has previously been authorized by the beneficiary.

(3) Unless otherwise stipulated in the undertaking or elsewhere agreed by the guarantor/issuer and the beneficiary, where any amendment has not previously been authorized by the beneficiary, the undertaking is amended only when the guarantor/issuer receives a notice of acceptance of the
amendment by the beneficiary in a form referred to in paragraph (2) of article 7.

(4) An amendment of an undertaking has no effect on the rights and obligations of the principal/applicant (or an instructing party) or of a confirmer of the undertaking unless such person consents to the amendment.

Article 9. Transfer of beneficiary's right to demand payment

(1) The beneficiary's right to demand payment may be transferred only if authorized in the undertaking, and only to the extent and in the manner authorized in the undertaking.

(2) If an undertaking is designated as transferable without specifying whether or not the consent of the guarantor/issuer or another authorized person is required for the actual transfer neither the guarantor/issuer nor any other authorized person is obliged to effect the transfer except to the extent and in the manner expressly consented to by it.

Article 10. Assignment of proceeds

(1) Unless otherwise stipulated in the undertaking or elsewhere agreed by the guarantor/issuer and the beneficiary, the beneficiary may assign to another person any proceeds to which it may be, or may become, entitled under the undertaking.

(2) If the guarantor/issuer or another person obliged to effect payment has received a notice originating from the beneficiary, in a form referred to in paragraph (2) of article 7, of the beneficiary's irrevocable assignment, payment to the assignee discharges the obligor, to the extent of its payment, from its liability under the undertaking.
Article 11. Cessation of right to demand payment

(1) The right of the beneficiary to demand payment under the undertaking ceases when:

(a) The guarantor/issuer has received a statement by the beneficiary of release from liability in a form referred to in paragraph (2) of article 7;

(b) The beneficiary and the guarantor/issuer have agreed on the termination of the undertaking in the form stipulated in the undertaking or, failing such stipulation, in a form referred to in paragraph (2) of article 7;

(c) The amount available under the undertaking has been paid, unless the undertaking provides for the automatic renewal or for an automatic increase of the amount available or otherwise provides for continuation of the undertaking;

(d) The validity period of the undertaking expires in accordance with the provisions of article 12.

(2) The undertaking may stipulate, or the guarantor/issuer and the beneficiary may agree elsewhere, that return of the document embodying the undertaking to the guarantor/issuer, or a procedure functionally equivalent to the return of the document in the case of the issuance of the undertaking in non-paper form, is required for the cessation of the right to demand payment, either alone or in conjunction with one of the events referred to in subparagraph (a) and (b) of paragraph (1) of this article. However, in no case shall retention of any such document by the beneficiary after the right to demand payment ceases in accordance with subparagraph (c) or (d) of paragraph (1) of this article preserve any rights of the beneficiary under the undertaking.

Article 12. Expiry

The validity period of the undertaking expires:
(a) At the expiry date, which may be a specified calendar date or the last day of a fixed period of time stipulated in the undertaking, provided that, if the expiry date is not a business date at the place of business of the guarantor/issuer at which the undertaking is issued, or of another person or at another place stipulated in the undertaking for presentation of the demand for payment, expiry occurs on the first business day which follows;

(b) If expiry depends according to the undertaking on the occurrence of an act or event not within the guarantor/issuer's sphere of operations, when the guarantor/issuer is advised that the act or event has occurred by presentation of the document specified for that purpose in the undertaking or, if no such document is specified, of a certification by the beneficiary of the occurrence of the act or event;

(c) If the undertaking does not state an expiry date, or if the act or event on which expiry is stated to depend has not yet been established by presentation of the required document and an expiry date has not been stated in addition, when six years have elapsed from the date of issuance of the undertaking.

CHAPTER IV. RIGHTS, OBLIGATIONS AND DEFENCES

Article 13. Determination of rights and obligations

(1) The rights and obligations of the guarantor/issuer and the beneficiary arising from the undertaking are determined by the terms and conditions set forth in the undertaking, including any rules, general conditions or usages specifically referred to therein, and by the provisions of this Convention.

(2) In interpreting terms and conditions of the undertaking and in settling questions that are not addressed by the terms and conditions of the undertaking or by the provisions of this Convention, regard shall be had to generally accepted international rules and usages of independent guarantee or stand-by letter of credit practice.
Article 14. Standard of conduct and liability of guarantor/issuer

(1) In discharging its obligations under the undertaking and this Convention, the guarantor/issuer shall act in good faith and exercise reasonable care having due regard to generally accepted standards of international practice of independent guarantees or stand-by letters of credit.

(2) A guarantor/issuer may not be exempted from liability for its failure to act in good faith or for grossly negligent conduct.

Article 15. Demand

(1) Any demand for payment under the undertaking shall be made in a form referred to in paragraph (2) of article 7 and in conformity with the terms and conditions of the undertaking.

(2) Unless otherwise stipulated in the undertaking, the demand and any certification or other document required by the undertaking shall be presented, within the time that a demand for payment may be made, to the guarantor/issuer at the place where the undertaking was issued.

(3) The beneficiary, when demanding payment, is deemed to certify that the demand is not in bad faith and that none of the elements referred to in subparagraphs (a), (b) and (c) of paragraph (1) of article 19 are present.

Article 16. Examination of demand and accompanying documents

(1) The guarantor/issuer shall examine the demand and any accompanying documents in accordance with standard of conduct referred to in paragraph (1) of article 14. In determining whether documents are in facial conformity with the terms and conditions of the undertaking, and are consistent with one another, the guarantor/issuer shall have due regard to the applicable international standard of independent guarantee or stand-by letter of credit practice.
(2) Unless otherwise stipulated in the undertaking or elsewhere agreed by the guarantor/issuer and the beneficiary, the guarantor/issuer shall have reasonable time, but not more than seven business days following the day of receipt of the demand any accompanying documents, in which to:

a) Examine the demand and any accompanying documents;
b) Decide whether or not to pay;
c) If the decision is not to pay, issue notice thereof to the beneficiary.

The notice referred to in subparagraph (c) above shall, unless otherwise stipulated in the undertaking or elsewhere agreed by the guarantor/issuer and the beneficiary, be made by teletransmission or, if that is not possible, by other expeditious means and indicate the reason for the decision not to pay.

**Article 17. Payment**

(1) Subject to article 19, the guarantor/issuer shall pay against a demand made in accordance with the provisions of article 15. Following a determination that a demand for payment so conforms, payment shall be made promptly, unless the undertaking stipulates payment on a deferred basis, in which case payment shall be made at the stipulated time.

(2) Any payment against a demand that is not in accordance with the provisions of article 15 does not prejudice the rights of the principal/applicant.

**Article 18. Set-off**

Unless otherwise stipulated in the undertaking or elsewhere agreed by the guarantor/issuer and the beneficiary, the guarantor/issuer may discharge the payment obligation under the undertaking by availing itself of a right of set-off, except with any claim assigned to it by the principal/applicant or the instructing party.
Article 19. Exception to payment obligation

(1) If it is manifest and clear that:

(a) Any document is not genuine or has been falsified;
(b) No payment is due on the basis asserted in the demand and the supporting documents; or
(c) Judging by the type and purpose of the undertaking, the demand has no conceivable basis,

the guarantor/issuer, acting in good faith, has a right, as against the beneficiary, to withhold payment.

(2) For the purposes of subparagraph (c) of paragraph (1) of this article, the following are types of situations in which a demand has no conceivable basis:

(a) The contingency or risk against which the undertaking was designed to secure the beneficiary has undoubtedly not materialized;

(b) The underlying obligation of the principal/applicant has been declared invalid by a court or arbitral tribunal, unless the undertaking indicates that such contingency falls within the risk to be covered by the undertaking;

(c) The underlying obligation has undoubtedly been fulfilled to the beneficiary;

(d) Fulfillment of the underlying obligation has clearly been prevented by willful misconduct of the beneficiary;

(c) In the case of a demand under a counter-guarantee, the beneficiary of the counter-guarantee has made payment in bad faith as guarantor/issuer of the undertaking to which the counter-guarantee relates.

(3) In the circumstances set out in subparagraphs (a), (b) and (c) of paragraph (1) of this article, the principal/applicant is entitled to provisional court measures in accordance with article 20.
CHAPTER V  PROVISIONAL COURT MEASURES

Article 20. Provisional court measures

(1) Where, on an application by the principal/applicant or the instructing party, it is shown that there is a high probability that, with regard to a demand made, or expected to be made, by the beneficiary, one of the circumstances referred to in subparagraphs (a), (b) and (c) of paragraph (1) of article 19 is present, the court, on the basis of immediately available strong evidence, may:

(a) Issue a provisional order to the effect that the beneficiary does not receive payment, including an order that the guarantor/issuer hold the amount of the undertaking, or

(b) Issue a provisional order to the effect that the proceeds of the undertaking paid to the beneficiary are blocked, taking into account whether in the absence of such an order the principal/applicant would be likely to suffer serious harm.

(2) The court, when issuing a provisional order referred to in paragraph (1) of this article, may require the person applying therefor to furnish such form of security as the court deems appropriate.

(3) The court may not issue a provisional order of the kind referred to in paragraph (1) of this article based on any objection to payment other than those referred to in subparagraphs (a), (b) and (c) of paragraph (1) of article 19, or use of the undertaking for a criminal purpose.

CHAPTER VI. CONFLICT OF LAWS

Article 21. Choice of applicable law

The undertaking is governed by the law the choice of which is:

(a) Stipulated in the undertaking or demonstrated by the terms and conditions of the undertaking; or

(b) Agreed elsewhere by the guarantor/issuer and the beneficiary.
Article 22. Determination of applicable law

Failing a choice of law in accordance with article 21, the undertaking is governed by the law of the State where the guarantor/issuer has that place of business at which the undertaking was issued.

CHAPTER VII. FINAL CLAUSES

Article 23. Depository

The secretary-general of the United Nations is the depository of this Convention.

Article 24. Signature, ratification, acceptance, approval, accession.

(1) This Convention is open for signature by all States at the Headquarters of the United Nations, New York, until ...[the date two years from the date of adoption].
(2) This Convention is subject to ratification, acceptance or approval by the signatory States.
(3) This Convention is open to accession by all States which are not signatory States as from the date it is open for signature.
(4) Instruments of ratification, acceptance, approval and accession are to be deposited with the secretary-general of the United Nations.

Article 25. Application to territorial units

(1) If a State has two or more territorial units in which different systems of law are applicable in relation to the matters dealt with in this Convention, it may, at the time of signature, ratification, acceptance, approval or accession, declare that this Convention is to extend to all its territorial units or only one or more of them, and may at any time substitute another declaration for its earlier declaration.

(2) These declarations are to state expressly the territorial units to which the Convention extends.
(3) If, by virtue of a declaration under this article, this Convention does not extend to all territorial units of a State and the place of business of the guarantor/issuer or of the beneficiary is located in a territorial unit to which the Convention does not extend, this place of business is considered not to be in a Contracting State.

(4) If a State makes no declaration under paragraph (1) of this article, the Convention is extend to all territorial units of that State.

**Article 26. Effect of declaration**

(1) Declaration made under article 25 at the time of signature are subject to confirmation upon ratification, acceptance or approval.

(2) Declaration and confirmations of declaration are to be in writing and to be formally notified to the depository.

(3) A declaration takes effect simultaneously with the entry into force of this Convention in respect of the State concerned. However, a declaration of which the depository receives formal notification after such entry into force takes effect on the first day of the month following the expiration of six months after the date of its receipt by the depository.

(4) Any State which makes a declaration under article 25 may withdraw it at any time by a formal notification in writing addressed to the depository. Such withdrawal takes effect on the first day of the month following the expiration of six months after the date of the receipt of the notification of the depository.

**Article 27 Reservations**

No reservations may be made to this Convention.
Article 28. Entry into force

(1) This Convention enters into force on the first day of the month following the expiration of one year from the date of the deposit of the fifth instrument of ratification, acceptance, approval or accession.

(2) For each State which becomes a Contracting State to this Convention after the date of the deposit of the fifth instrument of ratification, acceptance, approval or accession, this Convention enters into force on the first day of the month following the expiration of one year after the date of the deposit of the appropriate instrument on behalf of the State.

(3) This Convention applies only to undertakings issued on or after the date when the Convention enters into force in respect of the Contracting State referred to in subparagraph (a) or the Contracting State referred to in subparagraph (b) of paragraph (1) of article 1.

Article 29. Denunciation

(1) A Contracting State may denounce this Convention at any time by means of a notification in writing addressed to the depositary.

(2) The denunciation takes effect on the first day of the month following the expiration of one year after the notification is received by the depositary. Where a longer period is specified in the notification, the denunciation takes effect upon the expiration of such longer period after the notification is received by the depositary.

DONE at ...., this .......day of....one thousand nine hundred and ninety...., in a single original, of which the Arabic, Chinese, English, French, Russian and Spanish texts are equally authentic.

IN WITNESS WHEREOF the undersigned plenipotentiaries, being duly authorized by their respective Governments, have signed the present Convention.
APPENDIX D

UNIFORM COMMERCIAL CODE ARTICLE 5.

Section 5-101. SHORT ARTICLE.
This Article may be cited as Uniform Commercial Code-Letters of Credit.

Section 5-102. DEFINITIONS.
(a) In this article:

(1) "Adviser" means a person who, at the request of the issuer, a confirmer, or another adviser, notifies or requests another adviser to notify the beneficiary that a letter of credit has been issued, confirmed, or amended.

(2) "Applicant" means a person at whose request or for whose account a letter of credit is issued. The term includes a person who requests an issuer to issue a letter of credit on behalf of another if the person making the request undertakes an obligation to reimburse the issuer.

(3) "Beneficiary" means a person who under the terms of a letter of credit is entitled to have its complying presentation honored. The term includes a person whom drawing rights have been transferred under a transferable letter of credit.

(4) "Confirmer" means a nominated person who undertakes, at the request or with consent of the issuer, to honor a presentation under a letter of credit issued by another.

(5) "Dishonor" of a letter of credit means failure timely to honor or to take an interim action, such as acceptance of a draft, that may be required by the letter of credit.

(6) "Document" means a draft or other demand, document of title, investment security, certificate, invoice, or other record, statement, or representation of fact, law, right, or opinion (i) which is presented in a written or other medium permitted by the letter of credit or, unless prohibited by the letter of credit, by the standard practice referred to in Section 5-108(e) and (ii) which is capable of being examined for compliance with the terms and conditions of the letter of credit. A document may not be oral.

(7) "Goode faith" means honesty in fact in the conduct or transaction concerned.
(8) "Honor" of a letter of credit means a performance of the issuer's undertaking in the letter of credit to pay or deliver an item of value. Unless the letter of credit otherwise provides, "honor" occurs.

(i) upon payment,

(ii) if the letter of credit provides for acceptance, upon acceptance of a draft and, at maturity its payment, or,

(iii) if the letter of credit provides for incurring a deferred obligation, upon incurring the obligation and, at maturity, its performance.

(9) "Issuer" means a bank or other person that issues a letter of credit, but does not include an individual who makes an engagement for personal, family, or household purpose.

(10) "Letters of credit" means a definite undertaking that satisfies the requirement of Section 5-104 by an issuer to a beneficiary at the request or for the account of an applicant or, in the case of a financial institution, to itself or for its account, to honor a documentary presentation by payment or delivery of an item of value.

(11) "Nominated person" means a person whom the issuer (i) designates or authorizes to pay, accept, negotiate, or otherwise give value under a letter of credit and (ii) undertakes by agreement or custom and practice to reimburse.

(12) "Presentation" means delivery of a document to an issuer or nominated person for honor or giving of value under a letter of credit.

(13) "Presenter" means a person making a presentation as or on behalf of a beneficiary or nominated person.

(14) "Record" means information that is inscribed on a tangible medium, or that is stored in an electronic or other medium and is retrievable in perceivable form.

(15) "Successor of a beneficiary" means a person who succeeds to substantially all of the rights of a beneficiary by operation of law, including a corporation with or into which the beneficiary has been merged or consolidated, an administrator, executor, personal representative, trustee in bankruptcy, debtor in possession, liquidator, and receiver.

(b) Definitions in other Articles applying to this article and the sections in which they appear are:

"Accept" or "Acceptance" Section 3-409
"Value" Section 3-303, 4-211
(c) Article 1 contains certain additional general definitions and principles of construction and interpretation applicable throughout this article.

Section 5-103. SCOPE.
(a) This article applies to letters of credit and to certain rights and obligations arising out of transactions involving letters of credit.
(b) The statement of a rule in this article does not by itself require, imply, or negate application of the same or a different rule to a situation not provided for, or to person not specified, in this article.
(c) With the exception of this subsection, subsections (a) and (d), Sections 5-102(a)(9) and (10), 5-106(d), and 5-114(d), and except to the extent prohibited in Sections 1-102(3) and 5-117(d), the effect of this article may be varied by agreement or by a provision stated or incorporated by reference in an undertaking. A term in an agreement or undertaking generally excusing liability or generally limiting remedies for failure to perform obligations is not sufficient to vary obligations prescribed by this article.
(d) Rights and obligation of an issuer to a beneficiary or a nominated person under a letter of credit are independent of the existence, performance, or nonperformance of a contract or arrangement out of which the letter of credit arises or which underlies it, including contracts or arrangements between the issuer and the applicant and between the applicant and beneficiary.

Section 5-104 FORMAL REQUIREMENTS.
A letter of credit, confirmation, advice, transfer, amendment, or cancellation may be issued in any form that is a record and is authenticated (i) by a signature or (ii) in accordance with the agreement of the parties or the standard practice referred to in Section 5-108(e).

Section 5-105. CONSIDERATION.
Consideration is not required to issue, amend, transfer, or cancel a letter of credit, advice, or confirmation.

Section 5-106 ISSUANCE, AMENDMENT, CANCELLATION, AND DURATION.
(a) A letter of credit issued and becomes enforceable according to its terms against the issuer when the issuer sends or otherwise transmits it to the person
requested to advise or to the beneficiary. A letter of credit is revocable only if it so provides.

(b) After a letter of credit is issued, rights and obligations of a beneficiary, applicant, confirmer, and issuer are not affected by an amendment or cancellation to which that person has consented except to the extent the letter of credit provides that it is revocable or that the issuer may amend or cancel the letter of credit without that consent.

(c) If there is no stated expiration date or other provision that determines its duration, a letter of credit expires one year after its stated date of issuance or, if none is stated, after the date on which it is issued.

(d) A letter of credit that states that it is perpetual expires five years after its stated date of issuance, or if none is stated, after the date on which it is issued.

Section 5-109. FRAUD AND FORGERY.

(a) If a presentation is made that appears on its face strictly to comply with the terms and conditions of the letter of credit, but a required document is forged or materially fraudulent, or honor of the presentation would facilitate a material fraud by the beneficiary on the issuer or applicant:

(1) the issuer shall honor the presentation, if honor is demanded by forgery or material fraud, (ii) a confirmer who has honored its confirmation in good faith, (iii) a holder in due course of a draft drawn under the letter of credit which was taken after acceptance by the issuer or nominated person, or (iv) an assignee of the issuer's or nominated person's deferred obligation that was taken for value and without notice of forgery or material fraud after the obligation was incurred by the issuer or nominated person; and

(2) the issuer, acting in good faith, may honor or dishonor the presentation in any other case.

(b) If an applicant claims that a required document is forged or materially fraudulent or that honor of the presentation would facilitate a material fraud by the beneficiary on the issuer or applicant, a court of competent jurisdiction may temporarily or permanently enjoin the issuer from honoring a presentation or grant similar relief against the issuer or other persons only if the court finds that:

(1) the relief is not prohibited under the law applicable to an accepted draft or deferred obligation incurred by the issuer;
(2) a beneficiary, issuer, or nominated person who may be adversely affected is adequately protected against loss that it may suffer because the relief is granted;
(3) all of the conditions to entitle a person to the relief under the law of this State have been met; and
(4) on the basis of the information submitted to the court, the applicant is more likely than not to succeed under its claim of forgery or material fraud and the person demanding honor does not qualify for protection under subsection (a)(1).
APPENDIX E

Simple Demand Tender Guarantee

Our guarantee number

We are informed that

(hereinafter called the Seller) are tendering for a contract with you for the supply of

and that a tender guarantee is required in the sum of

On behalf of the Seller we Barclays Bank PLC [branch] hereby give you our guarantee and undertake to pay you any amount or amounts not exceeding in total a maximum of [amount] on receipt of your first demand in writing. Any claims must bear the confirmation of your bankers that the signatures thereon are authentic.

This guarantee is valid for written demands received by us on or before [date] after which date our liability to you under this guarantee will cease and this guarantee will be of no further effect.

This guarantee is personal to you and is not assignable.

This guarantee shall be governed by English law.
APPENDIX F

Conditional Demand Tender Guarantee

Our guarantee number

We are informed that

(hereinafter called the Seller) are tendering for a contract with you for the supply of

and that a tender guarantee is required in the sum of

On behalf of the Seller we Barclays Bank PLC [branch] hereby give you our guarantee and undertake to pay you any amount or amounts not exceeding in total a maximum of [amount] on receipt of your first demand in writing accompanied by your signed statement certifying that the Seller is in breach of his/her obligations under the tender conditions and either:
1. the Seller has without agreement withdrawn his/her tender during the period of the tender validity or
2. the contract to which this tender relates has been awarded to the Seller on the terms of such tender or on such other terms that have been specifically agreed by the Seller and that the Seller has failed to take up the contract or
3. the Seller has failed to provide the guarantee(s) required following the taking up of the contract.

Any claims must bear the confirmation of your bankers that the signatures thereon are authentic.

This guarantee is valid for written demands on us as set out above which are received by us on or before [date] after which date our liability to you under
this guarantee will cease and this guarantee will be no further effect. Any request for an extension of the above expiry date will only be considered by us if the request is signed by or on behalf of both yourselves and the Seller. This guarantee is personal to you and is not assignable. This guarantee shall be governed by English law.
APPENDIX G

Simple Demand Performance Guarantee

Our guarantee number

We are informed that

(hereinafter called the Seller) have entered into a contract with you dated

for the supply of

and that a bank guarantee for [amount] being % of the contract is required

On behalf of the Seller we Barclays Bank PLC [branch] hereby give you our guarantee and undertake to pay you amount or amounts not exceeding in total a maximum of [amount] on receipt of your first demand in writing. Any claims must bear the confirmation of your bankers that the signatures thereon are authentic.

This guarantee is valid for written demands by us on or before [date] after which date our liability to you under this guarantee will cease and this guarantee will be of no further effect.

This guarantee is personal to you and is not assignable.

This guarantee shall be governed by English law.
APPENDIX H
Conditional Demand Performance Guarantee

Our guarantee number

We are informed that

(hereinafter called the Seller) have entered into a contract with you dated

_for the supply of

and that a bank guarantee for [amount] being % of the contract is required

On behalf of the Seller we Barclays Bank PLC [branch] hereby give you our guarantee and undertake to pay you any amount or amounts not exceeding in total a maximum of [amount] on receipt of your first demand in writing provided either that it is counter-signed by the Seller as being a demand that is agreed by you both or that it is supported by a copy of an award relating to the above contract and to this guarantee made under the rules of conciliation and arbitration of the International Chamber of Commerce. Any claims must bear the confirmation of your bankers that the signatures thereon are authentic. This guarantee is valid for written demands received by us on or before [date] after which date our liability to you under this guarantee will cease and this
guarantee will be of no further effect provided always that neither you nor the Seller shall on or before the above date have given us written notice at our above address of an intention to resort to the arbitration procedure since in that event this guarantee will remain in force and effect until receipt by us of a notice of an arbitration award as provided above, or alternatively of a notice signed by or on behalf of both you and the Seller stating that a resort to arbitration has otherwise been terminated. This guarantee is personal to you and is not assignable. This guarantee shall be governed by English law.
APPENDIX I
Simple Demand Advance Payment Guarantee

Our guarantee number

We are informed that

(hereinafter called the Seller) have entered into a contract with you dated

for the supply of

and that under the terms of the contract you are to pay to the Seller the sum of

as an advance payment being % of the contract value

In consideration of the receipt by the Seller of the amount specified above to the credit of his account number [ ] at Barclays Bank PLC [branch] we Barclays Bank PLC [branch] hereby give you our guarantee and undertake to pay you any amount or amounts not exceeding in total a maximum of [amount] on receipt of your first demand in writing. Any claims must bear the confirmation of your bankers that the signatures thereon are authentic.
This guarantee is valid for written demands received by us on or before [date] after which date our liability to you under this guarantee will cease and this guarantee will be of no further effect.
This guarantee is personal to you and is not assignable.
This guarantee shall be governed by English law.
APPENDIX J
Conditional Demand Advance Payment Guarantee

Our guarantee number

We are informed that

(hereinafter called the Seller) have entered into a contract with you dated

for the supply of

and that under the terms of the contract you are to pay to the Seller the sum of

as an advance payment being % of the contract value

In consideration of the receipt by the Seller of the amount specified above to the credit of his account number [ ] at Barclays Bank PLC [branch] we Barclays Bank PLC [branch] hereby given you our guarantee and undertake to pay you any amounts not exceeding in total in maximum of [amount] on receipt of your first demand in writing accompanied by your signed statement certifying that the Seller is in branch of his obligations under the underlying contract, and the respect in which the Seller is in breach. Any claims must bear the confirmation of your bankers that the signatures thereon are authentic.

This guarantee is valid for written demands received by us on or before [date] after which date our liability to you under this guarantee will cease and this guarantee will be of no further effect.

This guarantee is personal to you and is not assignable.
This guarantee shall be governed by English law.
APPENDIX K
Standby Letter of Credit

IRREVOCABLE STANDBY CREDIT No:

To be quoted on all drafts and correspondence.

<table>
<thead>
<tr>
<th>Beneficiary (ies)</th>
<th>Advised through Advising Bank's Reference No.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
</tr>
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</table>

<table>
<thead>
<tr>
<th>Applicant's name</th>
<th>To be completed only if applicable.</th>
</tr>
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<tbody>
<tr>
<td></td>
<td>Our teleransmission of Advised through</td>
</tr>
<tr>
<td></td>
<td>Refers</td>
</tr>
</tbody>
</table>

Dear Sir(s)

In accordance with instructions received from ____________________________
we hereby issue in your favour a Documentary Credit for
available by your drafts drawn on ____________________ at
accompanied by the following documents:

Your signed statement that the applicant has failed to perform his/her
obligations under the terms of the contract dated [contract dated].
Any claims must bear the confirmation of your bankers that the signatures
thereon are authentic.
The credit is available for presentation of documents to us until __________
Drafts drawn hereunder must be marked 'Drawn under Barclays Bank PLC
[branch] [Credit number].
We undertake that drafts and documents drawn under and in strict conformity
with the terms of this will be honoured upon presentation.
Yours faithfully

Co-signed (Signature No. )  Signed (Signature No. )
APPENDIX L

Reduction Clause

The maximum amount of this guarantee will reduce by \(\%\) of the total value of invoices and bills of lading (or other stipulated documents) produced to us by the Seller which evidence the loading on board a vessel at a British Port of [goods] supplied under the terms of the above contract.

This guarantee will expire for written demands on us when we have received from the Seller invoices and relevant bills of lading (and/or other stipulated documents), the total value of which reduced as set out above equals or exceeds the maximum amount of this guarantee, or on [date] whichever is the earlier. Our liability to you under this guarantee will then cease and the guarantee will be of no further effect.
APPENDIX M
Operative Clause

It can sometimes be difficult to determine the exact time when the bank's liability will commence. Normally the bank will consider itself liable under its guarantee from the date on which it is issued. Letters of credit are often linked particularly to performance guarantees, and it may be agreed between beneficiary and applicant that a performance guarantee only becomes operative upon receipt by the seller of a letter of credit acceptable to the seller. An example of an operative clause is given below:

"This guarantee shall become operative upon issue of our amendment making it operative which will be issued upon receipt by us of written confirmation from the Seller that the latter has received an acceptable letter of credit".
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(Note) "Letters of Credit: Injunction As A Remedy For Fraud In UCC Section 5-114" [1979] Minnesota Law Review 487.

(Note) "Recent extensions in the use of commercial letters of credit" [1987] 66 Yale Law Journal 902


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