



# George Mason Journal of International Commercial Law

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## **Implementing the Standby Letter of Credit Convention with the Law of Wyoming**

James J. White\*

Since the sovereign states that make up the United Nations have not given that body the power to enact binding private law, some local mechanism must be employed in each state to transform any United Nations' convention into the law of a sovereign state. That mechanism is usually the act of a federal executive and federal legislature.

For the first time in American practice, we propose to implement a convention by a federal adoption of law previously enacted by the states—from Wyoming to New York—to implement the Convention on Independent Guarantees and Standby Letters of Credit (“Convention”).<sup>1</sup> This state law is Article 5 of the Uniform Commercial Code (“UCC”). In the words of the proposed federal legislation:

The purpose of this Act is to implement the Convention in the United States. This Act does that by giving effect to the choice of law provisions of the Convention and of Article 5 of the UCC.<sup>2</sup>

Under the rules set out in the proposed legislation, a letter of credit which is covered by the Convention but which has no choice of law provision will be governed, with two limited exceptions, by the law specified in section 5-116 (b) of the 2009 Official Text of Article 5. Section 5-116 (b) in turn directs one to the location of the person against whom liability is asserted (e.g., an issuer who is claimed to have wrongfully dishonored). Where that party is located in a state of the United States, section 5-116 directs—and the federal legislation expressly affirms—the use of the 2009 Official Text of Article 5 as “the Convention” in the United States.

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\* Robert A. Sullivan Professor Law, University of Michigan Law School. I thank Mark R. Christy, Michigan 2010 for his fine work.

<sup>1</sup> United Nations Convention on Independent Guarantees and Stand-by Letters of Credit art. 5, U.N. Doc. A/RES/50/48 (Dec. 11, 1995) [hereinafter The Convention].

<sup>2</sup> Committee to Implement the United Nations Convention on Independent Guarantees and Standby Letters of Credit, Report on the Implementation of the United Nations Convention on Independent Guaranties and Standby Letters of Credit 11 (2010), [http://www.law.upenn.edu/bll/archives/ulc/igasloc/2010june4\\_report.pdf](http://www.law.upenn.edu/bll/archives/ulc/igasloc/2010june4_report.pdf).

An UNCITRAL convention is a treaty for the purpose of American constitutional law and it must be adopted like any other treaty.<sup>3</sup> The process to make an UNCITRAL convention into American law has several steps. First a representative of the executive branch signs the convention, and then Congress must somehow “implement” it. Implementation can take several forms. Some conventions are “self-executing.” Those require only the consent of the Senate by a two-thirds vote and become effective as domestic law without any other act of either house of congress. Conventions that are not self-executing require some more elaborate action from Congress. If a treaty is not self-executing then implementation legislation is required before it takes effect as domestic law.<sup>4</sup> In this case, the implementation legislation calls for the adoption of state law as the United States’ implementation of the convention.

The only other significant private law convention that the United States has adopted, the Convention on Contracts for the International Sale of Goods (“CISG”), was ratified by the United States in 1986. Since that was a self-executing treaty, the text of the CISG became federal law by the Senate’s consent without Congressional enactment. Put differently, the CISG became effective as domestic law without any special implementation legislation, such as the legislation being proposed for the Convention.

In pages that follow I explain why the United States might chose to implement the Convention by use of state law, and I consider some of the interpretation issues that may arise from the American mode of implementation.

### Letters of Credit

The Convention was adopted by the United Nations General Assembly in 1995 and signed by the United States in December of 1997.<sup>5</sup> In

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<sup>3</sup> U.S. CONST. art. II, § 2, cl. 1 (describing the treaty-making process).

<sup>4</sup> The Supreme Court recently decided for the first time that a treaty-based claim was invalid on the grounds that the treaty in question was not self-executing. *Medellin v. Texas*, 128 S. Ct. 1346 (2008). The Court stated that a treaty requires implementing legislation to become effective unless “the treaty itself conveys an intention that it be self-executing and is ratified on these terms.” *Id.* at 1356. The *Medellin* opinion is likely to deter sponsors from using self-execution to implement a treaty until its meaning is clarified by later cases.

<sup>5</sup> James E. Byrne, *Report to the House of Delegates*, 1998 A.B.A. SEC. BUS. L. REP. 286, available at [http://www.law.upenn/bll/archives/ulc/igasloc/aba\\_res.pdf](http://www.law.upenn/bll/archives/ulc/igasloc/aba_res.pdf).

2008, an American committee (“Committee”) appointed by both the Uniform Law Commission and American Law Institute and working in conjunction with Mexican and Canadian authorities began considering the ratification of the Convention by the United States.<sup>6</sup> At this writing the Committee has produced proposed American Understandings and American commentary to accompany the Convention. The Convention will shortly be put before Congress for its consideration.<sup>7</sup> It will be accompanied with the Committee’s and the State Department’s proposal for American ratification.

As described earlier, the current plan for implementation of the Convention is to have Congress find that the various states’ adoption of Article 5 of the Uniform Commercial Code is implementation. So instead of making the text of the Convention federal law either as a self-executing treaty or by enactment as part of the United States Code, as Congress might have done, Congress is adopting the Official Text of Article 5 as the Convention.<sup>8</sup>

To understand why Americans might regard the adoption of a state law as the appropriate method of implementing an UNCITRAL convention, one needs to understand something about the making of commercial law under American federalism. Until the early part of the 20th century it would have been common understanding among lawyers in the United States that both practice and the United States Constitution made commercial law a subject for state, not federal enactment. Of course, Congress always had the power to enact laws—such as those dealing with bankruptcy—where the

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<sup>6</sup> Memorandum from James E. Byrne, Director, Institute of International Banking Law & Practice, to Edwin Smith, Chair, Drafting Committee for Implementation of the U.N. Convention on Independent Guarantees and Standby Letters of Credit (Oct. 22, 2007), available at [http://www.law.upenn.edu/bll/archives/ulc/igasloc/jeb\\_memo.pdf](http://www.law.upenn.edu/bll/archives/ulc/igasloc/jeb_memo.pdf).

<sup>7</sup> Memorandum from James J. White, Reporter, the Committee to Implement the UN Convention on Independent Guarantees and Stand-by Letters of Credit, to Uniform Law Commissioners (June 1, 2009), available at [http://www.law.upenn.edu/bll/archives/ulc/igasloc/2009june1\\_memo\\_pdf](http://www.law.upenn.edu/bll/archives/ulc/igasloc/2009june1_memo_pdf).

<sup>8</sup> Under the supremacy clause of the US Constitution “[t]reaties made, or which shall be made, under the Authority of the United States, shall be the supreme Law of the Land . . . .” U.S. Const. art. II, § 2, cl. 1. A self executing treaty is equal in status to congressional legislation and will preempt contrary state law. The implementation legislation required for a non-self-executing treaty is also a piece of federal legislation. In both cases, when there is a conflict between a treaty and a legislative act “the one last in date will control the other.” *Whitney v. Robertson*, 124 U.S. 190, 194 (1888). Presumably Congress’ blessing of Article 5 as the Convention will make it into federal law for that purpose as well, but that hypothesis has not been tested.



Constitution specifically granted the power to Congress.<sup>9</sup> Since the 1930's, the states' grip on commercial law has gradually weakened. The decisions in the 1930's and 1940's greatly expanded the conception of interstate commerce and broadened Congress' power to reach into apparently local affairs under the commerce clause of the Constitution.<sup>10</sup>

Despite the gradual encroachment on the states' monopoly, the most extensive and carefully drafted commercial law still comes from the states. The UCC, enacted by all of the states, governs not only the sale of goods, but also personal property security interests and even letters of credit. That law is generally superior to the law that Congress produces not only because of the care devoted to it, but also because it is more stable.<sup>11</sup> Much of the uncertainty in federal commercial law (such as the tax and bankruptcy codes) is introduced by the frequent Congressional amendments that those laws suffer at the hands of powerful special pleaders.<sup>12</sup> Presumably, because of the high cost of getting legislation through many state legislatures, state commercial law has escaped that kind of piecemeal change.

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<sup>9</sup> U.S. CONST. art. 1, §1.

<sup>10</sup> See, e.g., *Wickard v. Filburn*, 317 U.S. 111 (1942); *NLRB v. Jones & Laughlin Steel Corp.*, 301 U.S. 1 (1937); *United States v. Darby*, 312 U.S. 100 (1941).

<sup>11</sup> See, e.g., VA. CODE ANN. § 8.1A-103 (2003), and MICH. COMP. LAWS § 174-1962-1-2 (1962).

<sup>12</sup> A nice illustration of the confusion and uncertainty that Congress can sow is the "hanging paragraph" that it inserted in Section 1325(a) of the Bankruptcy Code in 2005. The text of the paragraph is incomprehensible to someone who does not know its history. Hanging from 11 USC § 1325(a), the paragraph reads: For purposes of paragraph (5), section 506 shall not apply to a claim described in that paragraph if the creditor has a purchase money security interest securing the debt that is the subject of the claim, the debt was incurred within the 910-day preceding the date of the filing of the petition, and the collateral for that debt consists of a motor vehicle (as defined in section 30102 of title 49) acquired for the personal use of the debtor, or if collateral for that debt consists of any other thing of value, if the debt was incurred during the 1-year period preceding that filing. One bankruptcy court complained of the "maddeningly inconsistent body of decisions." *In re Westfall*, 376 B.R. 210, 213 (Bankr. N.D. Ohio 2007). Another has pointed out that one of the problems is that "Congress failed to define "purchase money security interest" in the hanging paragraph or elsewhere." *Reiber v. GMAC, LLC (In re Peaslee)*, 547 F.3d 177, 184 (2d Cir. 2008). All of the many cases turn on the meaning of the purchase money phrase where a debtor has added the outstanding balance on a trade into the balance on his new car. The first court of appeals decision to address the meaning of this paragraph was *In re Graupner*, 537 F.3d 1295 (11th Cir. 2008). The court discusses the wide divergence of opinions in the district courts and bankruptcy courts regarding the issue and agrees with other courts that have said that the text is poorly drafted.

The states have fought federal intrusion, and Congress has shown neither the interest nor the patience necessary to produce first-rate commercial law.<sup>13</sup> The American law that covers standby letters of credit, the topic of the Convention, is Article 5 of the UCC. Completely revised in 1995, Article 5 is up-to-date and consistent with commercial practices both in the United States and abroad. In fact, revised Article 5 doubtless had an influence on the drafting of the Convention.

Even if Article 5 is up-to-date and conforming to commercial practice, the fact that the text of the Convention in the United States will be the UCC and not that of the Convention and that an American judge will usually interpret the Convention not by use of its language but by use of the words in Article 5, will present nettlesome issues. In the pages that follow I discuss some of those.

### Official Text

An American court applying the Convention will be directed to look at the text of the UCC,<sup>14</sup> not at the text of the Convention. In the case of the CISG, Senate ratification of the CISG as a self-executing treaty made the text of that convention American federal law. Had it chosen to follow the route that is being proposed for the letter of credit convention, Article 2 of the Uniform Commercial Code, not the CISG itself, would be the text of that convention in the United States. So under the CISG approach there is but one text; under the current approach for the Convention, there will be two.

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<sup>13</sup> Both the United States Income Tax Code and the Bankruptcy Code are covered with ugly patches and stuffed with amendments that make them unintelligible to the average lawyer. For example, see Thomas E. Lauria & Kevin McGill, *Strict Construction of the Bankruptcy Code: Is the Ability to Avoid Clean-up Obligations and Substantive Consolidation at Risk?* (2006), available at [http://www.whitecase.com/files/Publication/04bead52-fe7e-4c01-8cde01e64b3886c6/Presentation/PublicationAttachment/8e626ef206df-4af0-a9d710e582f7370f/article\\_Strict\\_Construction\\_of\\_the\\_Bankruptcy\\_Code.pdf](http://www.whitecase.com/files/Publication/04bead52-fe7e-4c01-8cde01e64b3886c6/Presentation/PublicationAttachment/8e626ef206df-4af0-a9d710e582f7370f/article_Strict_Construction_of_the_Bankruptcy_Code.pdf).

<sup>14</sup> Memorandum from James J. White, Reporter, the Committee to Implement the UN Convention on Independent Guarantees and Stand-by Letters of Credit, to Uniform Law Commissioners (June 1, 2009), available at [http://law.upenn.edu/bll/archives/ulc/igasloc/2009june1\\_memo.pdf](http://law.upenn.edu/bll/archives/ulc/igasloc/2009june1_memo.pdf). Because the Convention is in direct conflict with Article 5 on setoff, and on the time of expiration of a letter that does not state a time of expiration, new federal or separate new state law will deal with those issues.

When litigation over a standby letter of credit covered by the Convention occurs in a foreign state, the court there will look to the text of the Convention. An American court dealing with the same issue will often use the text of Article 5 of the UCC.<sup>15</sup> To the extent that ambiguities lie undiscovered in the words of the Convention or the words of Article 5, the American mode of implementation may produce conflicting interpretations of the correlative sections in the Convention and in Article 5 of the UCC.<sup>16</sup>

Consider the case of “document.” That word is defined both in Article 5 of the UCC and in Article 6 of the Convention. Article 6(g) defines the word as “a communication made in the form that provides a complete record thereof.” Under this definition a digital message can qualify as a document. By contrast Section 5-102(6) has an extensive definition of the same word that excludes digital documents unless the digital format is a “medium permitted by the letter of credit or ... by the standard practice referred to in section 5-108(e) ... .”

The United States commentary to Article 6 of the Convention asserts:

That “document” is defined broadly enough to include digital documents does not by itself authorize one who is making presentation under the Convention to present documents in digital or other non-paper form. Thus where there is no authority in the undertaking or in the practice applicable to the undertaking to authorize the use of a digital document, the presentation of a digital document would render the presentation non-complying both under the Convention and under Article 5 of the UCC.”<sup>17</sup>

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<sup>15</sup> *Id.* at 1-2.

<sup>16</sup> *See id.* The direction in Article 13 of the Convention to determine rights and obligations in part by “the provisions of this Convention” will not direct a court to the text of the Convention because the text of Article 5 of the UCC will be “the Convention” in the United States.

<sup>17</sup> Commentary for the United Nations Convention on Independent Guarantees and Standby Letters of Credit 5 (March, 26 2008), available at <http://www.law.upenn.edu/bll/archives/ulc/igasloc/2008march26%20ccd.pdf>. The commentary includes a proposed “understanding” with respect to the definitions. Because the understanding does not apply to terms that are defined in the Convention it does not technically apply to the hypothetical. The understanding reads as follows, “terms used but not defined in the Convention, (a) have the same or substantially similar meanings to the terms defined in the official text of Article 5 of the UCC ..., or (b) if there is no definition in UCC Article 5, have the meanings found elsewhere in the UCC, or (c) if there is no definition in the UCC, have meanings equivalent to the same or substantially similar terms used in Article 5 of the UCC

To test the accuracy of the American commentary, consider a hypothetical case. Assume a standby letter of credit without a choice of law clause issued by an American Bank to a French beneficiary that calls for the presentation of a document without specifying the medium in which the document must be formed. Assume the beneficiary presents a document in digital format to the American issuer and the issuer declines to pay on the ground that the document was not in writing. If the beneficiary sues the issuer in the United States for its failure to pay, a court would look at Article 5 of the UCC and at the United States commentary and conclude that no “document” had been presented and thus no proper presentation was made. If, on the other hand, the case were brought in a foreign court, the court would presumably look to the text of the Convention and to any commentary or understanding in the foreign court's jurisdiction, but not at Article 5 of the UCC and not at the United States commentary. Unless its own commentary called for a different result, the foreign court would conclude that a “document” had been presented and that the presentation was proper. So the issuer would have liability for failing to pay if the case were tried abroad, but not if it were tried in the United States.

I am assuming that an American court would regard the United States commentary concerning the definitions at least as persuasive and possibly as conclusive. I am also assuming that the foreign court would look to the mode of implementation in its own country and would not feel bound to deviate from the text of the Convention simply because a semi-official committee in some other country stated its opinion to the contrary.

Whether the Committee's commentary on the general consistency between the Convention and the UCC has been too sanguine remains to be seen. If I am correct about the two courts' search for governing law, we have one example where the same case gets different results in an American court and a foreign court. I have identified only one potential point of conflict. Driven by their clients' interest, clever lawyers will surely find many more.

### **Opting Into the Convention Text**

Because the United States proposes to implement the Convention by use of the UCC and to direct its courts to apply the text of the UCC in lieu of the Convention's text, foreign banks or lawyers acting on behalf of foreign beneficiaries or banks may wish to limit an American court to the

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(e.g., “documentary” and “non-documentary” as used in the Convention or the UCC to describe a type of undertaking, condition or presentation). *Id.* at 12.

Convention's text and to prevent it from using the text of the UCC. Can that be done?

The Committee intended so. When this issue was raised, the Committee was unanimous that the law should be interpreted to grant the power to the parties to a letter of credit to force an American court to interpret the rights under the letter of credit by use of the text of the Convention and not the text of the UCC. Section 5(a) of the proposed federal act that will be put before Congress currently directs an American court to use the "text" of the Convention to any letter "that expressly states that it is governed by the Convention..."<sup>18</sup>

### American Case Law

What does the direction to use Article 5 as the text portend for case law? In cases covered by the Convention, are American courts to rely on American cases interpreting Article 5? And what if an American case interpreting a provision of Article 5 disagrees with a case in a foreign jurisdiction interpreting the analogous point under the Convention?

Article 5 of the Convention directs that "regard be had to [the Convention's] international character and to the need to promote uniformity in its application..." The most obvious reading of that exhortation is that an American court should regard foreign courts' interpretation of the Convention to be persuasive if not binding.

But the American commentary supports the opposite inference: "Article 5 [of the Convention] does not mean that a court interpreting the Convention should ignore the local law that may implement the Convention but merely that the court should pay due attention to cases that interpret the Convention..."<sup>19</sup> The reference to "local law" is broad enough to include not only Article 5 of the UCC but also cases decided under the UCC.

Assume a standby that calls for payment only on presentation of a certificate of default by Robert Stein, the mayor of Ypsilanti. Assume that

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<sup>18</sup> Committee to Implement the United Nations Convention on Independent Guarantees and Standby Letters of Credit, Report on the Implementation of the United Nations Convention on Independent Guaranties and Standby Letters of Credit 8-9 (2010), *available at* [http://www.law.upenn.edu/bll/archives/ulc/igasloc/2010june4\\_report.pdf](http://www.law.upenn.edu/bll/archives/ulc/igasloc/2010june4_report.pdf).

<sup>19</sup> Letter of Submittal, The United Nations Convention on Independent Guarantees and Standby Letters of Credit with the United States Commentary (May 7, 2009), *available at* [http://www.law.upenn.edu/bll/archives/ulc/igasloc/2009may7\\_letter.pdf](http://www.law.upenn.edu/bll/archives/ulc/igasloc/2009may7_letter.pdf)

Stein does not run for reelection and that his successor mayor Luther Jones signs the certificate of default. Assume further that the Supreme Court of Illinois finds the presentation proper. Two years later the identical issue is presented to an Illinois court under an international standby letter of a French bank governed by the Convention and assume that there are French and English cases under the Convention that hold that such a presentation (i.e., a certificate by a successor and not by the person named in the letter) is not compliant with such a letter. Is the court to follow the unanimous reading of the Convention by foreign courts or must it follow Illinois case law?

Following the deviant Illinois case hardly “promotes uniformity” even if one might conclude that paying “due attention” to foreign cases does not require a court to treat them as binding precedent.<sup>20</sup> In my view any court finding itself in that position should, at the least, look for ways to distinguish the local cases and follow the foreign interpretations. After all this is international trade law and a principal purpose of the law is to make the applicable rules the same in all countries that have implemented the Convention.

### **Changes in Article 5 of the UCC**

It is easy to adopt Article 5 of the UCC as the Convention, but what about non-uniform provisions? And what about amendments that are adopted in some or many states after the Convention has been implemented? The proposed federal legislation uses the 2009 official text; state deviations must be ignored by a court that is deciding a case under the Convention.

And if after 25 years the Uniform Law Commission undertakes a complete revision of Article 5 of the UCC, then what? In that case the Commission and the ALI could and doubtless should return to Congress for a new federal statute to implement the Convention anew by reference to the newly revised Article 5. But what if there is no new federal enactment after the adoption of a revision to Article 5 of the UCC. Since the current draft of the federal implementing statute makes the 2009 Article 5 the American version of the Convention, state adoption of a new Article 5 (or even the ULA and ALI adoption of a new official text) will bring the ironic

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<sup>20</sup> See U.C.C. § 5-101 cmt. (1977).

consequence that a new Article 5 would be the current official or state law but the superseded 2009 version would be the Convention.

To continue to apply a repealed version of Article 5 of the UCC to international letters of credit because that former text constitutes “the Convention” in the United States seems absurd. However, the hypothetical case demonstrates a significant potential difficulty that can arise from doing what we now propose. Once the United States makes Article 5 the “text” of a convention, there is a new impediment to the improvement of Article 5 or of any other part of our commercial law that has been used as the mode of adoption of an UNCITRAL convention.<sup>21</sup> And if Congress fails to adopt the Convention anew, there is the possibility that the Convention would consist not of the prevailing Article 5 but of a repealed version.

### Understandings

“Understandings” are the weakest of the unilateral qualifications that a state can make to the terms of a convention.<sup>22</sup> At least in theory an understanding does not change the legal effect of a convention; it merely “clarifies” the meaning.<sup>23</sup> Of course, any lawyer is instinctively skeptical of something that clarifies but does not change. American common lawyers are trained to believe that all formal interpretations of a text, whether by a court, an agency or the Pope, alter the meaning of the text and that is doubly true if the interpreting body is the highest court of the state interpreting state law or a legislature that has adopted the law.

The proposal that will be submitted to Congress states four American Understandings (Understanding(s)). They deal with Article 6 (Definitions), Article 20 (Provisional Court Measures), Article 21 (Choice of Applicable Law), and Article 22 (Determination of Applicable Law).<sup>24</sup> I

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<sup>21</sup> All of the original Articles (1, 3, 4, 5, 6, 7, 8 and 9) of the UCC except for Article 2 have been extensively revised and some (3, 4, and 9) have been revised twice.

<sup>22</sup> Other unilateral acts of adopting states are “reservations” and “declarations.” A reservation is an outright statement of rejection of the terms of a convention. Article 27 of the Convention prohibits a state that adopts the Convention from stating any reservations. Declarations are sometimes used to select among alternatives that have been left by the drafters for a state’s own choice. The Convention, *supra* note 1, art. 25.

<sup>23</sup> *Id.* arts. 25, 27.

<sup>24</sup> Commentary for the United Nations Convention on Independent Guarantees and Standby Letters of Credit 12-13 (March, 26 2008), available at <http://www.law.upenn.edu/bll/archives/ulc/igasloc/2008march26%20ccd.pdf>.

discuss some implications for interpretation of the Convention that arise from the first and the third.

The Understanding on Article 6 adopts the UCC definitions—in Article 5 and elsewhere—for any case where a term is not defined in the Convention but there is a definition of that term (e.g., good faith) or of a substantially similar term in the UCC.

In the year 2050, assume that a Chicago Bank examines a documentary presentation electronically and concludes that the presentation complies with the undertaking. Assume that the applicant objects to the bank's payment on the ground that such a mode of examination does not conform to "reasonable care" that is required by Article 14 of the Convention. May the Bank defend by citing section 3-103(a)(9) of the UCC? That section finds that a bank that examines an instrument by electronic means (and presumably never casts human eyes on it) is acting with ordinary care.<sup>25</sup> Of course, the applicant will argue that the Article 3 definition of ordinary care does not apply to the examination of anything but checks, but if the judge rejects that argument under the UCC, can he then apply the UCC definition to Article 14? The Understanding seems to say so.

At minimum, the upshot of the Understanding on definitions will require foreign and American letter of credit lawyers to have some familiarity not only with section 5-102, but also with sections 1-201, 2-103, 3-103, 4-104, and 9-102, the other UCC definitional sections. The Understanding, as currently written, does not apply to cases where there is a definition in the Convention, but if the Convention is Article 5 in the United States that will not matter for cases before American courts. An American court applying the Convention will already have Article 5 of the UCC before it.

When a letter of credit "issued from the United States" provides for the application of the law of a state of the United States, the Understanding concerning Article 21 states that the undertaking is governed by "the substantive law in the UCC." As I suggest above, the Convention may be the substantive law in the UCC in any case, but in a foreign court that would otherwise use the Convention's text, this Understanding would make clear that Article 5, not the Convention is the governing text.

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<sup>25</sup> Assuming, *arguendo*, that "ordinary care" has the same meaning as "reasonable care."



What language in an undertaking is sufficient to “provide for the application of the law of a state of the United States?” Does the choice of the “law of New York” suffice? Some courts have found that similar words choose the CISG (as federal law applicable in the state whose law is chosen), not Article 2 of the UCC as the drafter of the language likely intended.<sup>26</sup> I suspect that the proposed Understanding would change that outcome for the Convention. That conclusion is supported by the current version of the federal implementing legislation that says in Section 5(c) any “undertaking that expressly states that it is governed by the law of a State shall be governed by the law of that State and not by the Convention.”<sup>27</sup> Cautious lawyers might wish to refer to the “New York UCC” or use similar language as suggested by the commentary to Article 21.<sup>28</sup> If, as currently proposed, the Convention is implemented by Congress’ reference to the Official Text of Article 5 and if the courts take to that plan, the issue will have little practical importance.

### Conclusion

Even if the use of Article 5 to implement the Convention increases the likelihood of conflicts between the Convention’s text and the text of Article 5, that increase is trivial. Constructing the American Convention out

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<sup>26</sup> See, e.g., *BP Oil Int'l, Ltd. v. Empresa Estatal Petroleos de Ecuador*, 332 F.3d 333, 337 (5th Cir. 2003) (stating that “If the parties decide to exclude the Convention, it should be expressly excluded by language which states that it does not apply and also states what law shall govern the contract”); *Travelers Prop. Cas. Co. of Am. v. St.-Gobain Tech. Fabrics Can., Ltd.*, 474 F. Supp. 2d 1075, 1082 (D. Minn. 2007) (stating that “absent an express statement that the CISG does not apply, merely referring to a particular state’s law does not opt out of the CISG”). The courts reason here that the states are bound by the treaty under the supremacy clause, so merely stating that the “law of New York applies” is not enough. In other words, the CISG is domestic law and applies absent an express intent to opt out, so if the parties just name the law of the state as the choice of law then they are just confirming that the treaty applies. Cf. *Am. Biophysics Corp. v. Dubois Marine Specialties*, 411 F. Supp. 2d 61, 63 (D.R.I. 2006) (stating that “subsection 11(h) of the Agreement provides that the Agreement ‘shall be construed and enforced in accordance with the laws of the state of Rhode Island.’ That provision is sufficient to exclude application of the CISG.”)

<sup>27</sup> Committee to Implement the United Nations Convention on Independent Guarantees and Standby Letters of Credit, Report on the Implementation of the United Nations Convention on Independent Guaranties and Standby Letters of Credit 12 (2010), [http://www.law.upenn.edu/bll/archives/ulc/igasloc/2010june4\\_report.pdf](http://www.law.upenn.edu/bll/archives/ulc/igasloc/2010june4_report.pdf).

<sup>28</sup> E.g., “[T]his undertaking ... is governed by the New York UCC and as to matters outside the scope of ISP98 and the UCC, by New York State and United States federal laws.” Or “this undertaking is governed by the New York UCC.”

of carefully drafted law with which American lawyers and judges are familiar—in style if not in substance—outweighs the risk of conflict. The clarity of the UCC, the presence of its comments, and guidance from cases under the Code, make it far more likely that an American lawyer or judge will find the correct answer in that regime than they would if the Senate were merely to adopt the Convention text as a self executing treaty. So despite the interpretive issues that I raise here, I think we are right to use Article 5 of the UCC as the implementing tool.

## Reimbursement under the Standby Letter of Credit Convention

Rafael Illescas \*

### 1. Possible Reimbursement Situations under the Standby Letter of Credit Convention

The United Nations Convention on Independent Guarantees and Stand-by Letters of Credit<sup>1</sup> (the Convention) gives rise to a variety of interesting and commercially significant scenarios involving reimbursement. The Convention was approved by the UN General Assembly on 11 December 1995 and entered into force on 1 January 2000, making it the only international source of law for letters of credit and demand guarantees.<sup>2</sup> Reimbursement is a situation where a person obliged or entitled to pay the guarantee (or standby) amount to the beneficiary (i.e. a confirming bank, nominal bank, or the issuer or guarantor), pays it and subsequently demands repayment of the paid sum from another person. Ultimately, the person from whom reimbursement is sought is typically

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\* Professor of Commercial Law, Carlos III University, Madrid; Chairman of UNCITRAL Working Group on International Contract Practices for several of the sessions during which the Convention was drafted and delegate from Spain during the entire series of meetings from 1988 to 1995. Professor James E. Byrne has assisted in suggesting English terminology to implement my intended meaning. I remain very grateful for his cooperation.

<sup>1</sup> United Nations Convention on Independent Guarantees and Stand-by Letters of Credit art. 5, Dec. 11, 1995, A/RES/50/48, *available at* <http://www.uncitral.org/pdf/english/texts/payments/guarantees/guarantees.pdf> [hereinafter The Convention]. As of 1 November 2010, eight nations have ratified or acceded to the Convention: Belarus, Ecuador, El Salvador, Gabon, Kuwait, Liberia, Panama and Tunisia. The United States of America has signed the Convention but has not yet ratified it or acceded to it. United Nations Treaty Status Database ch. X § 15, <http://treaties.un.org/doc/Publication/MTDSG/Volume%20I/Chapter%20X/X-15.en.pdf> (last visited Nov. 1, 2010).

<sup>2</sup> Notably, but for the Convention there is no international law concerning letters of credit. There are a few instances of national law that may be highlighted. Within the United States, the law with regard to “standby letters of credit, the topic of the Convention, is Article 5 of the Uniform Commercial Code (UCC). Completely revised in 1995, Article 5 is up-to-date and consistent with commercial practices both in the United States and abroad.” James White, *Implementing the Standby Letter of Credit Convention with the Law of Wyoming*, 1 Geo. Mason J. Int'l Comm. L. 1, 5 (2010). The text of UCC Article 5 is available at <http://www.law.cornell.edu/ucc/5/>. Within the People's Republic of China (PRC), the People's Supreme Court has provided a set of judicial interpretations, referred to as the PRC letter of credit rules. The Institute of International Banking Law and Practice has published an unofficial, English translation of these rules. See INSTITUTE OF INTERNATIONAL BANKING LAW AND PRACTICE, LC RULES AND LAWS (4<sup>th</sup> ed. 2010).

within the circle of those persons who seek issuance of the standby or guarantee, either in conjunction with the guarantee or standby's issuance or the underlying transaction. They are known under practice rules as "applicants" and will be so named in this article although the UN LC Convention refers to this party as the "principal/applicant."<sup>3</sup> The Convention does not expressly mention reimbursement; nor does the Convention expressly attribute to anyone the right to be reimbursed from any payment made pursuant the standby or guarantee. However, the Convention does describe events or situations in which reimbursement should be considered as a natural consequence of payment under the standby or independent guarantee.<sup>4</sup>

Although the UN LC Convention does not address questions of reimbursement, it does recognize the important role of rules of practice.<sup>5</sup>

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<sup>3</sup> At the time of the drafting of the UN LC Convention, demand guarantee practice was in the process of liberating itself conceptually from that of accessory or suretyship guarantees. As a result, the term "principal" was in common use for independent guarantees as is reflected in the Convention text, which provides "[t]he undertaking may be given: (a) At the request or on the instruction of the customer ('principal/applicant') of the guarantor/issuer ... ." The Convention, *supra* note 1, art. 2(2)(a). Applicants are also known as "customers" or "account parties." The *Uniform Customs and Practices for Documentary Credits 600* (UCP600) states in Article 2 (Definitions) that "[a]pplicant means the party on whose request the credit is issued." *The Uniform Customs and Practice for Documentary Credits (UCP600)*, International Chamber of Commerce [ICC] Publ'n No. 600 art. 2 (July 1, 2007) [hereinafter UCP600]. The *International Standby Practices 98* (ISP98) states in Rule 1.09(a) (Definitions), "[a]pplicant' is a person who applies for issuance of a standby of for whose account it is issued, and includes (i) a person applying in its own name but for the account of another person or (ii) an issuer acting for its own account." *The International Standby Practices 1998* (ISP98), R. 1.09(a), ICC Publ'n No. 590 (Jan. 1, 1999) [hereinafter ISP98]. The *Uniform Rules for Demand Guarantees 458* (URDG458) alludes to issuance "at the request or on the instructions and under the liability of a party (hereinafter called the 'Principal') ... ." *Uniform Rules for Demand Guarantees (URDG458)*, ICC Publ'n No. 458 art. 2(i) (1992) [hereinafter URDG458]. The 2010 revision to URDG458, *Uniform Rules for Demand Guarantees 758* (URDG758), abandons "principal" in favor of "applicant" and provides in Article 2 (Definitions) that "applicant means the party indicated in the guarantee as having its underlying obligation supported by the guarantee." *Uniform Rules for Demand Guarantees (URDG758)*, International Chamber of Commerce Publ'n No. 758 art. 2 (2010) [hereinafter URDG758].

<sup>4</sup> The Convention, *supra* note 1, arts. 2(2)(b), 6(c)-(e).

<sup>5</sup> *See id.* art. 13 ("(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

Among these contractual or customary governing rules<sup>6</sup>—with optional or supplementary meaning—must be mentioned the International Standby Practices (ISP98),<sup>7</sup> the Uniform Rules for Bank-to-Bank Reimbursements under Documentary Credits (URR525),<sup>8</sup> the Uniform Customs and Practice for Documentary Credits (UCP600)<sup>9</sup> and Uniform Rules for Demand Guarantees (URDG), all having been endorsed by the International Chamber of Commerce (ICC).<sup>10</sup> These rules are more explicit concerning reimbursements, although the UCP deals with commercial letters of credit, which are not the focus of the Convention.<sup>11</sup>

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to *generally accepted international rules and usages* of independent guarantee or stand-by letter of credit practice.”) (emphasis added); *id.* art. 14(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.”) (emphasis added); and *id.* art. 16(1) (“The guarantor/issuer shall examine the demand and any accompanying documents in accordance with the 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.*”) (emphasis added).

<sup>6</sup> These rules could be understood to be “contractual” in the sense that they are voluntary obligations. Technically, there is no “agreement”, since the undertaking unilaterally states that it is subject to them. However, though there is no obligation on the part of the beneficiary to act under the undertaking the beneficiary does so with awareness of the applicability of the rules as a condition of the undertaking, which is, in effect, incorporated by reference. Many of the rules also reflect standard international letter of credit practice and, as such, are customary and have been applied in the absence of a contrary provision in the undertaking even where it is not expressly subject to them.

<sup>7</sup> See ISP98, *supra* note 3.

<sup>8</sup> *Uniform Rules for Bank-to-Bank Reimbursements under Documentary Credits (URR525)*, ICC Publ'n No. 525 (1996) [hereinafter URR525].

<sup>9</sup> UCP600, *supra* note 3. This revision replaced *The Uniform Customs and Practice for Documentary Credits (UCP500)*, ICC Publ'n No. 500 (January 1, 1994), which was in effect at the time that the drafting of the Convention was completed.

<sup>10</sup> URDG458, *supra* note 3, was in effect at the time that the Convention was completed. An early version of these rules was considered at a meeting of the Working Group in 1988. There is no reference to reimbursement in this version. URDG458 was revised effective 1 July 2010 and replaced with URDG758, which expressly contemplates reimbursement in Articles 21 and 22 and implies reimbursement situations in Articles 23, 24, 25, 26 and 33. See URDG758, *supra* note 3.

<sup>11</sup> *But cf.* The Convention, *supra* note 1, Article 1(2) (expressly permitting commercial letters of credit to incorporate the convention).

As will be explained in following paragraphs, the parties to a standby or demand guarantee can refer in the text of the standby or demand guarantee to a number of “rules, general conditions or usages” that are separate texts apart from the Convention.<sup>12</sup> Furthermore, the Convention provides that “regard shall be had to generally accepted international rules and usages of independent guarantee or stand-by letter of credit practice.”<sup>13</sup> That means that not only the Convention but also other rules of practice can govern directly or indirectly the standby or demand guarantee and any related reimbursements whether provided for therein or otherwise available.<sup>14</sup>

Though not expressly mentioned in its text, there are at minimum three reimbursement situations contemplated by the Convention:

- i) After payment to the beneficiary, the issuer asks for reimbursement from the instructing party or principal/applicant. Article 2 of the Convention describes this situation.<sup>15</sup> The transfer of funds from the instructing party to the issuer before the issuance of the standby or demand guarantee or even after its issuance but before any payment to the beneficiary under the guarantee is *not* considered a reimbursement. However, such a transfer is very similar with only one particular difference, namely the moment in which the issuer or guarantor is funded is not after to payment to the beneficiary on the independent undertaking but prior to it. Though the moment of satisfaction is different, in both situations the issuer or guarantor is reimbursed for its payment, whether anticipated or actual.<sup>16</sup>

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<sup>12</sup> *Id.* art. 13(1).

<sup>13</sup> *Id.* art. 13(2).

<sup>14</sup> UNCITRAL, Explanatory note by the UNCITRAL Secretariat on the United Nations Convention on Independent Guarantees and Stand-by Letters of Credit cmt. 5, U.N. Doc. A/CN.9/431 (July 4, 1996), *available at*, <http://daccess-ods.un.org/TMP/9645256.html>.

<sup>15</sup> The Convention, *supra* note 1, art. 2 (“[t]he undertaking may be given (a) at the request or instruction of the ... “principal/applicant” ... [or] (b) on the instruction of [an] ... “instructing party” that acts at the request of the customer ...”).

<sup>16</sup> *Id.* art. 6(c).

- ii) After payment to the guarantor-issuer or issuer of the counter-standby of a local guarantee or counter-standby in favor of a local beneficiary by the counter-guarantor, the latter can claim reimbursement for the amount paid from its instructing party or applicant. Article 6(c) of the Convention contemplates this type of reimbursement.<sup>17</sup>
- iii) After payment to the Beneficiary by the Confirmer, the latter can claim for reimbursement of the paid amount from the issuer under the definition contained in Art. 6(e) of the Convention.<sup>18</sup> It is not clear in practice whether the confirmer has a right to claim reimbursement directly from the applicant in the event that the issuer is insolvent. The issue is more readily resolved under commercial letters of credit where the documents typically represent commercial goods that are of value to the applicant although the location of the documents is important. Where they are tied up in the liquidation of the issuer, the applicant will not readily agree to reimburse the confirmer. With respect to standby letters of credit, it is rare that the documents have any inherent value. This issue is interstitial under the Convention and would probably be resolved under local law. However, UCP600 Art. 7(c) refers to reimbursement without reference to the given value. This provision is fully consistent with the independence of standbys and guarantees with respect to the underlying transaction.<sup>19</sup>

Reimbursement situations expressly contemplated under the above-mentioned additional non-convention texts—particularly under ISP98—are the following:

- i) With regard to the ISP98, there is an initial reimbursement provision concordant with the situation described in Article 2 of the Convention: “[w]here a payment is made against a complying presentation, reimbursement must be made by ... an applicant to an issuer requested to issue a standby ... .”<sup>20</sup>

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<sup>17</sup> *Id.*

<sup>18</sup> *Id.*

<sup>19</sup> *Id.* art. 7(c).

<sup>20</sup> ISP98, *supra* note 3, R. 8.01(a)i.

- ii) Reimbursement must also be made by “an issuer to a person nominated (in the standby) to honour or otherwise give value.”<sup>21</sup> ISP98 Rule 8.02(a), which is formulated to take into account other purposes, establishes a list of nominated persons: “persons nominated with the applicant’s consent to advise, confirm, honour, negotiate, transfer, or to issuer a separate undertaking.”<sup>22</sup> In the case of issuance of a transferable standby, a transfer of drawing rights can be made by the beneficiary to a third party. If this occurs, the issuer or other nominated person must honor the drawing by this another person as if that person were the beneficiary as provided in ISP98 Rule 6.01.<sup>23</sup> In this case, pursuant to ISP98 Rule 6.05, the issuer or nominated person that has paid against a regular transfer of the standby is entitled to reimbursement as if it had made payment to the beneficiary.<sup>24</sup> As usually is the case when transfer of rights is made, this situation is very complex and nuance is necessary. It should be noted that the transfer is made not with regard to a property right or a credit but with regard to the right to draw against the issuer of the transferred standby.
- iii) Any issuer or nominated person paying under acknowledged assignment of proceeds under a standby pursuant to ISP98 Rule 6.08 is “entitled to reimbursement as if it has made payment to the beneficiary.”<sup>25</sup> ISP98 clearly states that the right to claim and the conditions for acknowledgement of assignment of proceeds is a situation completely different than the transfer or negotiation of the standby.<sup>26</sup> In fact, an assignment relates solely to the proceeds and not to the rights under the standby. For a continental jurist, it

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<sup>21</sup> *Id.* R. 8.01(a)ii.

<sup>22</sup> *Id.* R. 8.02.

<sup>23</sup> *Id.* R. 6.01 (“Where a beneficiary requests that an issuer or nominated person honour a drawing from another person as if that person were the beneficiary, these Rules on transfer of drawing rights (“*transfer*”) apply.”).

<sup>24</sup> *Id.* R. 6.05 (“An issuer or nominated person paying under a transfer pursuant to Rule 6.03(a), (b)(i), and (b)(ii) is entitled to reimbursement as if it had made payment to the beneficiary.”).

<sup>25</sup> *Id.* R. 6.10.

<sup>26</sup> *Id.*



represents a situation similar in concept to differentiating between legitimacy and titularity.

- iv) Under a standby issued pursuant to ISP98, any issuer or nominated person paying under a transfer by operation of law is entitled to reimbursement as if it has made payment to the beneficiary.<sup>27</sup> While Rule 6.14 clearly states the right to claim, ISP98 Rule 6.12 sets out various conditions to be fulfilled in order to made the claim: presentation of an additional document which appears to be issued by a public official and indicates that the claimant is a successor of the initial beneficiary as consequence of a structural modification of a corporation, an insolvency proceeding, or the death or incapacity of a natural person.<sup>28</sup>

Additional reimbursement situations expressly contemplated under the above mentioned non-conventional texts—particularly under UCP600—are the following:

- i) Pursuant to UCP600, a reimbursement situation occurs when “an issuing bank undertakes to reimburse a nominated bank that has honoured or negotiated a complying presentation of a documentary credit and forwarded the documents to the issuing bank.”<sup>29</sup> The same article indicates other circumstances—for instance, time and independency of undertakings—concerning the reimbursement.<sup>30</sup> Furthermore, it is necessary to recall UCP600 Article 12(a) concerning the circumstances under which the nominated bank is entitled to reimbursement under the credit.<sup>31</sup>
- ii) Pursuant to UCP600, “a confirming bank undertakes to reimburse another nominated bank that has honoured or negotiated a complying presentation of a documentary credit and forwarded the documents to the issuing bank.”<sup>32</sup> The article indicates other

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<sup>27</sup> *Id.* R. 6.14.

<sup>28</sup> *Id.* R. 6.12.

<sup>29</sup> UCP600, *supra* note 3, art. 7(c).

<sup>30</sup> *Id.*

<sup>31</sup> *Id.* art. 12(a).

<sup>32</sup> *Id.* art. 8(c).

additional circumstances—time and independence of the undertaking—concerning the reimbursement, in a manner similar to UCP600 Article 7(c).<sup>33</sup>

In fact, the rules governing reimbursements under UCP600 complement the provisions of the Convention concerning the relationship between the parties to a standby. The Convention's text, as stated above, does not contain specific provisions on reimbursement; it merely describes situations in which the natural consequence would be a reimbursement. In short, the Convention is silent as it pertains to the particularities of a reimbursement. Accordingly, UCP600 Articles 7 and 8 complement the Convention in that they expressly mention the right of the paying bank under a documentary credit—or a standby as is demonstrated *infra*—to be reimbursed by the issuer or confirming banks.<sup>34</sup>

## 2. Applicable Law

As indicated *supra*, the Convention was designed to be the applicable law with respect to reimbursements under a standby or demand guarantee. The fact, however, that the Convention makes no mention of reimbursement forces one to search for additional and express rules of practice governing the issue. In performing that task, the Articles 13 and 14 of the Convention are especially helpful in finding additional norms to the Convention provisions. The extent of their relevance is as follows:

- i) Article 13(1) makes reference to “rules, general conditions or usages specifically referred to therein (the stand-by)” in order to determine the rights and obligations arising from the undertaking.<sup>35</sup>
- ii) Article 13(2) states that regard shall be had to “generally accepted international rules and usages of independent guarantee or stand-by letter of credit practice” in interpreting terms and conditions of the undertaking and in settling questions that are not addressed by the conditions of the undertaking or the provisions of the Convention.<sup>36</sup>

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<sup>33</sup> *Id.* arts. 7(c), 8(c).

<sup>34</sup> *Id.* arts. 7-8.

<sup>35</sup> The Convention, *supra* note 1, art. 13(1).

<sup>36</sup> *Id.* art. 13(2).

- iii) Article 14(1) makes a third express reference to customary rules and practices that are globally accepted. However, the reference is made with a more limited scope: only to supplementary customary rules governing the discharge of the issuer or guarantor's obligations under the undertaking and the Convention by the guarantor/issuer. This person "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*" (emphasis added).<sup>37</sup>

Thus, the Convention is not alone in determining rights and obligations of the parties to a standby at the moment of their exercise or discharge. The Convention text is complemented by rules, general conditions or usages specifically referred to by the standby and also by generally accepted international standards, rules and usages of independent guarantee or standby letter of credit practice, irrespective of specific facial mention in the standby itself. Accordingly, the mandates formulated by Articles 13 and 14 of the Convention open the door to the qualification as applicable law to the reimbursement regime under a standby to ISP98, UCP600, and also, *mutatis mutandis*, URR 525. It is my opinion that these three rules of practice serve an interpretation function for the Convention regardless of their own discrete internal provisions and requirements. For example, the incorporation into the text of the Reimbursement Authorization in the case of the URR 525<sup>38</sup> is not necessary when the rules are used solely to aid in the interpretation of the Convention according to Articles 13(2) and 14(1).

### 3. Legal Requirements for Reimbursement

It is useful to identify a comprehensive list of legal requirements to be satisfied by the claimant in order to obtain reimbursement of its payment to the beneficiary made under a standby. Some common requirements can be identified taking into account the Convention provisions and all the supplementary applicable rules arising from the international practice. They are common in that the applicable law requires their fulfillment in all the cases of reimbursement previously mentioned. These common requisites are prior payment and the conformity of the demand.

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<sup>37</sup> *Id.* art. 14(1) (emphasis added).

<sup>38</sup> URR525, *supra* note 8, art. 1.

Prior payment is the first condition in order to claim reimbursement from the issuer or any other person. The payment should be made in accordance with the Convention: payment when the presentation is made, deferred payment if so provided in the standby or as a result of set-off.<sup>39</sup> What appears impossible under the Convention is to claim reimbursement without having made previous payment. Where the bank that claims reimbursement, for example, charged the issuer or confirmer's account without having made payment, the issuer can ask for a provisional measure or injunction to impede any payment under the standby, thus excluding reimbursement.<sup>40</sup> Where the issuer or guarantor charges the applicant or instructing party's account without having become obligated, it remedies must be in the reimbursement agreement. Where a nominated bank has not honored, it is not entitled to reimbursement either. In addition, the issuer or guarantor can also assert a defence that the demand for reimbursement has been made without prior payment. With regard to reimbursement by the issuer, the prior payment condition is crystal clear in ISP98 Rule 8.01.<sup>41</sup> This clarity appears also in other applicable rules in the International Standby Practices.<sup>42</sup>

Payment must be made at the appropriate moment. That means that if the standby provides for a deferred payment, the reimbursement claim should be made after the exhaustion of the deferred period for payment.<sup>43</sup>

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<sup>39</sup> The Convention, *supra* note 1, arts. 17 (“(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.”); and *id.* art 18 (“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.”).

<sup>40</sup> *Id.* art. 20.

<sup>41</sup> ISP98, *supra* note 3, R. 8.01 (stating “where payment is made against a complying presentation in accordance with these Rules” as a precondition to any reimbursement).

<sup>42</sup> See *supra* notes 23-31 and accompanying text.

<sup>43</sup> The Convention, *supra* note 1, art. 17(a) (“payment shall be made promptly, unless the undertaking stipulates payment on a deferred basis ...”).

The second condition for reimbursement involves the necessity of a conforming demand prior to payment. The demand and accompanying documents, if any, should comply with the facial requirements stated in the standby unless the rule of preclusion operates. As Article 15 of the Convention provides, any demand for payment under the undertaking shall be made "... in conformity with the terms and conditions of the undertaking."<sup>44</sup>

The conformity of the demand with respect to the claim for reimbursement is also required by Article 17(1) of the Convention<sup>45</sup> and is also reflected in ISP98.<sup>46</sup> The legal consequences of a non-complying presentation are fatal with respect to the reimbursement (except where the preclusion rule operates). As established in Article 17(2) of the Convention "any payment against a demand that is not in accordance with the provision of Article 15 does not prejudice the rights of the principal/applicant."<sup>47</sup> This implies that any subsequent reimbursement claim made by the paying person against the instructing party will not succeed in view of the lacking conformity of the presentation.

A standby can nominate persons who are entitled, typically with the applicant's consent, to confirm, honor, pay, negotiate, transfer or issue a separate undertaking (for instance, a counter-guarantee or counter-standby). Notably, a claim for reimbursement made subsequent to payment by a nominated person will only succeed if the nomination of the paying person was made by the issuer as indicated by ISP98 Rule 8.02(a).<sup>48</sup>

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<sup>44</sup> *Id.* art. 15.

<sup>45</sup> *Id.* art. 17(1) ("Following a determination that a demand for payment so conforms (to Article 15), payment shall be made ...").

<sup>46</sup> See ISP98, *supra* note 3, R. 8.02, 6.05, 6.10, 6.14 (the conformity in general is less explicit than the specific conformity and documental demonstration of the concerned transfer, assignment of proceeds or transfer by operation of law).

<sup>47</sup> The Convention, *supra* note 1, art. 17(2).

<sup>48</sup> ISP98, *supra* note 3, Rule 8.02(a) ("An applicant must pay the issuer's charges and reimburse the issuer for any charges that the issuer is obligated to pay to persons nominated with the applicant consent to advise, confirm, honour, negotiate, transfer, or to issue a separate undertaking").

## Fraud and the UN Convention on Independent Guarantees and Standby Letters of Credit

Dr. Alan Davidson\*

This paper considers the approach and adoption of the fraud exception to the principle of autonomy by the United Nations Convention on Independent Guarantees and Standby Letters of Credit (Convention). The Convention incorporates a forthright and shrewd definition of fraud whilst simultaneously avoiding the use of the word “fraud.” The drafters succeed in finding a test for fraudulent behavior in easily understandable terms, whilst maintaining flexibility in application and adhering to the spirit of international banking practice and experience. The paper further considers the background, nature and internationality of the Convention to place its treatment of the fraud exception in context.

### Introduction

The Convention was adopted on December 11, 1995 by the General Assembly of the United Nations,<sup>1</sup> specifically the Working Group on International Contract Practices at its thirteenth to twenty-third sessions.<sup>2</sup> The Convention became effective on January 1, 2000 having been ratified, accepted, approved or acceded to by the minimum five nations, the required

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<sup>1</sup> See also Filip De Ly, *The UN Convention on Independent Guarantees and Standby Letters of Credit*, 33 INT'L LAW 831 (1999); James E. Byrne, *Independent Guarantee Convention*, in 1999 ANNUAL SURVEY OF LETTER OF CREDIT LAW AND PRACTICE 93 (James Byrne ed., 1999); John F. Dolan, *The UN Convention on International Independent Undertakings: Do States with Mature Letter-of-Credit Regimes Need It?*, in 1999 ANNUAL SURVEY OF LETTER OF CREDIT LAW AND PRACTICE 97 (James Byrne ed., 1999).

<sup>2</sup> See 1990 UNCITRAL Y.B. XXI, U.N. Doc. A/CN.9/330, U.N. Sales No. E.91.V.6 (1990); 1991 UNCITRAL Y.B. XXII: U.N. Doc. A/CN.9/342 and A/CN.9/345, U.N. Sales No. E.93.V.2 (1991); 1992 UNCITRAL Y.B. XXIII: U.N. Doc. A/CN.9/358 and A/CN.9/361, U.N. Sales No. E.94.V.7 (1992); 1993 UNCITRAL Y.B. XXIV: U.N. Doc. A/CN.9/374 and Corr.1, U.N. Sales No. E.94.V.16 (1993); 1994 UNCITRAL Y.B. XXV: U.N. Doc. A/CN.9/388 and A/CN.9/391, U.N. Sales No. E.95.V.20 (1994); 1995 UNCITRAL Y.B. XXVI U.N. Doc. A/CN.9/405 and A/CN.9/408 (1995); The deliberations of UNCITRAL on the Convention, 28<sup>th</sup> Sess., 1995 Official Records of the General Assembly, 50th Sess., Supp. (No. 17), ¶¶ 11-201, U.N. Doc. A/50/17.

number of nations. To date eight nations have ratified or acceded to the Convention.<sup>3</sup>

The Convention is designed to facilitate the use of independent guarantees and standby letters of credit. It toughens general principles and features that are common to independent guarantees and the standby letters of credit.<sup>4</sup>

The overwhelming majority of the world's independent guarantees and standby letters of credit are subject to three rules of practice: the Uniform Customs and Practice for Documentary Credits (UCP), the International Standby Practices (ISP98) and the Uniform Rules of Demand Guarantees (URDG). These rules of practice are incorporated into the transaction by agreement between the commercial parties.

Where a nation has acceded to or ratified the Convention, then the Convention applies by force of law since the rules of private international law determine the proper law of the transaction. The Convention drafters were cognizant of the need to settle rules and practices into law relating to independent undertakings, independent guarantees and standby letters of credit.

### **Background**

The history of the Convention indicates that the drafters recognized a need to settle rules and practices into law relating to independent undertakings. Notably, the drafters included specific provisions for a prime exception to the principle of autonomy: the fraud exception.<sup>5</sup> The Convention aims to provide greater legal certainty by making a single legal regime available for both independent guarantees and stand-by letters of credit. The official Explanatory Note to the Convention states that the Convention supplements the operation of the UCP, the ISP98 and the URDG by dealing with issues beyond the scope of such rules, in particular

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<sup>3</sup> Belarus, Ecuador, El Salvador, Gabon, Kuwait, Liberia, Panama and Tunisia. The United States of America has signed the Convention but, as of 1 November 2010, not yet acceded to it.

<sup>4</sup> See generally Byrne, *supra* note 2, at 93; De Ly, *supra* note 2, at 831; Dolan, *supra* note 2, at 97.

<sup>5</sup> See John F. Dolan, *supra* note 2, at 97, 99.

fraudulent or abusive demands for payment and the subsequent judicial remedies.<sup>6</sup>

Limited application and acceptance has meant that the Convention currently has little practical importance to most commercial parties. Nevertheless, the Convention has provided an opportunity for bankers, lawyers and interested participants to address and redress issues that the UCP, ISP98 and the URDG were unable to tackle. The nature of the UCP, ISP98 and URDG is such that the parties are unable to define the level of fraud, which may apply or be acceptable in a given transaction. At the common law level, principles of contract would not permit a party to contract out of fraud, or to redefine the level of fraud applicable.

The UCP600, ISP98 and URDG are non-mandatory rules. Each is intended to standardize the conditions applicable to documentary credits, standby letters of credit and for the URDG, demand guarantees. The rules do not have force of law though bankers, merchants and customers in the vast majority of countries use these extensively, often with great reverence. However, some commentators have argued that the UCP is so well known and accepted that it has the force of law<sup>7</sup> and should be considered a truly universal norm.<sup>8</sup> According to former UNCITRAL Secretary Gerold Herrmann, the purpose of the Convention is “to codify the principle of independence ... in a legally binding manner and not merely rely on the non-binding rules of the ICC set out in the UCP500 or the URDG.”<sup>9</sup>

As specified in Article 2(1) of the Convention, it is intended to apply to independent guarantees and standby letters of credit. The former are sometimes referred to as demand, first demand, simple demand or bank guarantees. Both independent guarantees and standby letters of credit share a wide area of common use, and are legally indistinguishable.

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<sup>6</sup> See UNCITRAL, Explanatory note by the UNCITRAL Secretariat on the United Nations Convention on Independent Guarantees and Stand-by Letters of Credit, cmt. 8, U.N. Doc. A/CN.9/431 (July 4, 1996), available at <http://daccess-ods.un.org/TMP/9645256.html> [hereinafter Explanatory Note].

<sup>7</sup> Gerold Herrmann, *The UNCITRAL Draft Convention on Independent Guarantees and Stand-by letters of Credit*, in ATTORNEY GENERAL'S DEPARTMENT AND LAW COUNCIL OF AUSTRALIA TWENTY FIRST INTERNATIONAL TRADE LAW CONFERENCE 325 (1994).

<sup>8</sup> Boris Kozolchyk, *Bernard Spencer Wheble (1904-1998) In Memoriam*, in 1999 ANNUAL SURVEY OF LETTER OF CREDIT LAW AND PRACTICE 18, 21 (James Byrne ed., 1999).

<sup>9</sup> Herrmann, *supra* note 7, at 326.



The autonomy principle is a prominent feature of the Convention. The official Explanatory Note to the Convention refers to the independent undertakings as “basic tools of international commerce.”<sup>10</sup> The drafters were concerned that “there has been a lack of uniformity internationally in the understanding and recognition of that essential characteristic” in relation to undertakings of the type covered by the Convention.<sup>11</sup> Article 3 clarifies that the primary undertaking is independent from any underlying transaction (performance, financial or otherwise), counter-guarantees or confirmations. The Convention specifically clarifies and defines counter-guarantees and confirmations as primary undertakings.<sup>12</sup>

The independence appropriately extends to terms or conditions not appearing in the undertaking. In documentary credit parlance, non-documentary conditions are to be disregarded. Specifically, an undertaking should not be subject to any future, uncertain act or event other than the actual presentation of documents. This approach is consistent with the line of authority that the role of the guarantor and issuer is “one of paymaster rather than investigator.”<sup>13</sup>

As a corollary to the autonomy principle, is the fact that the undertaking, the guarantor’s or issuer’s obligation, is documentary in nature. Hence, letters of credit are typically referred to as documentary credits. The guarantor’s and issuer’s obligation is to examine documents when presented with the requisite demand. The duty of the guarantor and issuer is to only deal with the documents. One consequence is that non-documentary conditions are beyond the scope of the Convention.

The specific intent behind the Convention is to deal with the independent relationship between the guarantor (in the case of the independent guarantee) and the issuer (in the case of the standby letter of credit) with the beneficiary. Because the independent commitments under

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<sup>10</sup> Explanatory Note, *supra* note 6, cmt. 3.

<sup>11</sup> *Id.* cmts. 17-18.

<sup>12</sup> United Nations Convention on Independent Guarantees and Stand-by Letters of Credit, art. 6(c), (e), U.N. Doc. A/RES/50/48 (Dec. 11, 1995) [hereinafter The Convention]. As with commercial letters of credit the beneficiary has the option of demanding payment from the counter guarantor or confirmer.

<sup>13</sup> Explanatory Note, *supra* note 6, cmt. 18.

the Convention are given to a beneficiary, the focal point of the Convention is on this relationship. Conversely, the relationship between the guarantor or issuer with and the corresponding customer (the principal in the case of an independent guarantee, or the applicant in the case of a standby letter of credit) generally is not a matter for treatment by the Convention.<sup>14</sup> Notably, the Convention does not apply to accessory or conditional guarantees, such as, guarantees where the obligation to pay involves more than just the examination of documents. In summary, the Convention is concerned with the independence of the obligation between the guarantor and issuer with the beneficiary.

### **Commercial and Standby Letters of Credit**

The Convention envisages applicability to commercial letters of credit, at the option of the parties. Article 2 defines the type of undertaking to which the Convention is intended to apply, specifically: “an independent commitment, known in international practice as an independent guarantee or as a stand-by letter of credit.” However Article 1(2) provides that the 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.” These “opt-in” provisions provide an opportunity for the parties in commercial letters of credit to incorporate international law, potentially creating a unified standard, for such issues as fraud, abusive drawings and jurisdiction. The power of the Convention is the ability to supplant deficiencies in rules such as the UCP and ISP. These rules of practice are highly restricted and proved durable time and time again. The deficiencies are merely their inability to deal with the issues of law available to the Convention.

### **Application of the Convention**

The Convention can apply in three circumstances. First, the Convention applies to an “international undertaking” if: (a) the place of business of the guarantor or issuer at which the undertaking is issued is in a Contracting State, or (b) the rules of private international law lead to the application of the law of a Contracting State.<sup>15</sup> Despite a minor controversy, the parties to the undertaking may exclude the application of the

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<sup>14</sup> *Id.* cmt. 6.

<sup>15</sup> The Convention, *supra* note 12, art. 1(1).

Convention in this manner.<sup>16</sup>

Second, the Convention applies to other international letters of credit where the letter of credit expressly states that it is subject to the Convention. Article 1(2) permits the parties to letters of credit other than standby letters of credit to “opt into” the Convention. The drafters of the Convention have stated that there is “broad common ground between commercial and standby letters of credit,” and “in view of the occasional difficulties in determining whether a letter of credit is of a standby or commercial variety” parties to commercial letters of credit may “in their own judgment” take advantage of the convention.<sup>17</sup>

Third, and independently of Article 1(1), Articles 21 and 22 of the Convention provide that the undertaking is governed by the choice of law stipulated in the undertaking, demonstrated by the terms and conditions of the undertaking or agreed elsewhere by the parties.<sup>18</sup> In the absence of such a choice of law, the law of the State where the guarantor or issuer has its place of business at which the undertaking was issued governs the undertaking.

### **Internationality of the Undertaking**

The Convention clearly applies to international undertakings<sup>19</sup> and international letters of credit<sup>20</sup>. Strictly, the Convention cannot be applied to

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<sup>16</sup> The controversy centered around, what has been described as a scrivener’s error. In the draft Convention, the exclusion provision appears on a new line and would apply appropriately to both paragraphs (a) and (b). In the initial officially published Convention, the words in the Article were identical, however, the exclusion provision appears to be part of paragraph (b). More than one commentator noted the apparent “confusion.” See John F. Dolan, *supra* note 2, at 97, 99; Paul S. Turner, *The New UN Convention on Standby Letters of Credit: How Would it Affect Existing US Letter of Credit Law?*, in LETTERS OF CREDIT REPORT 1 (Nov./Dec. 1996). However, the draft Convention was adopted by the General Assembly without amendment. Moreover, the official Explanatory Note provides that “(f)ull freedom is given to parties to exclude completely the coverage of the Convention.” Explanatory Note, *supra* note 6, cmt. 11. Clearly, there was no intention to change the draft, and the expression “scrivener’s error” is accurate.

<sup>17</sup> Explanatory Note, *supra* note 6, cmt. 16.

<sup>18</sup> The Convention, *supra* note 12, arts. 21, 22.

<sup>19</sup> *Id.* art.1(1), (3).

<sup>20</sup> *Id.* art. 1(2).

purely domestic letters of credit. However, the need and subsequent use of letters of credit purely domestically is minimal and the Convention's definition of internationality is quite broad. Article 4(1) provides that an undertaking is international if the places of business, as specified in the undertaking, of any two of the guarantor/issuer, beneficiary, principal/applicant, instructing party or confirmer are in different States. Where 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. Where the undertaking does not specify a place of business for a given person but does specify the "habitual residence" that residence is relevant for determining the international character of the undertaking.<sup>21</sup>

### Nature of the Undertaking

The Convention defines the applicable undertaking as an independent commitment, known in international practice as an independent guarantee or as a standby letter of credit. The undertaking is given by a bank, other institution or person (termed the guarantor or 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.<sup>22</sup>

The language attempts to isolate the common characteristics of independent guarantees and standby letters of credit as instruments of finance. In the words of the official Explanatory Note,<sup>23</sup> the Convention "solidifies recognition of common basic principles and characteristics shared" by the two instruments.<sup>24</sup> Indicative of this common understanding,

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<sup>21</sup> *Id.* art. 4(2).

<sup>22</sup> *Id.* art. 2(1).

<sup>23</sup> The official Explanatory Note to the Convention was prepared by the secretariat of UNCITRAL for informational purposes. It is not an official commentary on the Convention. Explanatory Note, *supra* note 6, n.1.

<sup>24</sup> *Id.* cmt. 2.

the Convention uses the neutral expression “undertaking” to refer to both instruments.

### **Independence of the Undertaking**

At the actual heart of the Convention is the concept of independence—the autonomy principle. The official Explanatory Note describes the independent undertakings covered by the Convention as “basic tools of international commerce.” The Convention drafters believed there had been a lack of uniformity internationally in the understanding and recognition of the autonomy principle in relation to undertakings of the type covered by the Convention.<sup>25</sup> One stated aim of the Convention is to promote international uniformity. The Convention defines “independence” in Article 3, which clarifies that the undertaking is independent from any underlying transaction (performance, financial or otherwise) and also from any counter-guarantee or confirmation.<sup>26</sup> The Convention recognizes counter-guarantees and confirmations. Both terms are defined in the Convention<sup>27</sup> in a similar manner to a primary undertaking. As with commercial letters of credit the beneficiary has the option of demanding payment from the counter guarantor or confirmer.

The Convention is designed to be consistent with the parties’ use of the UCP, the ISP98 and the URDG. The Convention supplements these rules of practice by dealing with additional issues beyond the scope of such rules applying as law, described thus: “important questions confronting users, practitioners and courts in the daily life of these instruments are beyond the power of the parties to settle contractually.” Hence the drafters of the Convention could engage in debate and consideration of issues beyond the scope of the drafter of the rules of practice: vis-à-vis fraud.

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<sup>25</sup> *Id.* cmts. 17-18.

<sup>26</sup> The Convention, *supra* note 12, art. 3 (“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 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 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.”).

<sup>27</sup> *Id.* art. 6 (c), (e).

### Relationship between the Convention and Rules of Practice

The Convention provides that rights and obligations arising from the undertaking are determined by the terms and conditions in the undertaking. Specific reference is made to applicable rules of practice such as the UCP, URDG and ISP98. Article 13(2) provides:

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.<sup>28</sup>

The Convention's approach maintains maximum flexibility for the parties in preparing the undertaking. This ensures that the Convention will remain a living instrument, and that the emerging and developing practices under the UCP, URDG and ISP98 are necessarily incorporated. For example, at the time the Convention was finalized the ISP98 was in its infancy. Nevertheless, the flexible approach necessarily permits the incorporation of these new rules. As the Explanatory Note details:

(the) approach ensures that the Convention will remain a living instrument, sensitive to developments in practice, including future revisions of rules of practice such as UCP and URDG and the development of *other international rules of practice*.<sup>29</sup>

This flexible approach of linking the Convention to the needs and evolving usages and standards of commercial practice is also dealt with in other parts of the Convention. For example, the interpretation provisions<sup>30</sup> and the standard of conduct of the guarantor or issuer.<sup>31</sup>

The Convention supplements other rules of international practice, but is able to take questions of applicable law further. Rules of practice are adopted by parties as terms in a contract. As terms of the contract, rules of

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<sup>28</sup> *Id.* art. 13(1).

<sup>29</sup> Explanatory Note, *supra* note 6, cmt. 36 (emphasis added).

<sup>30</sup> The Convention, *supra* note 12, art. 13(2).

<sup>31</sup> *Id.* art. 14(1).

practice may give rights and impose obligations on the parties; however, the parties cannot contract to permit a fraud. In part because the Convention can address questions of applicable law, it goes further than rules of practice in addressing the question of fraudulent or abusive demands for payment and judicial remedies. In this case, the applicable law may be UCC Revised Article 5-109 or the UN Convention Article 19.<sup>32</sup>

### The Fraud Standard

Fraud is a major factor for any bank that handles letters of credit and demand guarantees. Any attempt to reduce the ability to perpetrate a fraud should be applauded and changes in practice introduced.<sup>33</sup>

As mentioned, jurisdiction and fraud are two matters that the rules of practice cannot deal with. These are matters, which by necessity should be left to the law because government and public policy issues are involved. In the matter of the fraud exception the law must take the lead. There are a few examples where the law has taken a lead and a fraud standard has been mandated, such as Uniform Commercial Code Revised Article 5, Section 109 and the Chinese Supreme Court Letter of Credit Rules.

Exemption clauses cannot operate to exclude or restrict liability for fraud by the perpetrator of the fraud.<sup>34</sup> This statement implies that the point is clear, but the fact that commercial parties have inserted such clauses may go to the factual and practical situation of reliance and subsequently to the proof of misrepresentation. In *Walker v Boyle*<sup>35</sup> the English High Court held that a clause stating, “[t]he properties are believed to be correctly described and any incorrect statement, error or omission in the particulars shall not

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<sup>32</sup> James E Byrne, *The Official Commentary on the International Standby Practices* 20, (James G. Barnes ed., 1998).

<sup>33</sup> Gary Collyer et al., *How to Revise the UCP: DWC Experts Give Their Suggestions*, DOCUMENTARY CREDIT WORLD, May 1999, at 19.

<sup>34</sup> ELIZABETH MACDONALD, EXEMPTION CLAUSES AND UNFAIR TERMS 300 (Butterworths 1999). See also *S. Pearson & Son v. Dublin Corp* (1907) AC 351, 362, 365 (House of Lords); *Scheider v. Heath* (1813) 3 Camp 506; *Garden Neptune Shipping Ltd. v. Occidental Worldwide Inv. Corp.* (1990) 1 LI Rep 330; *Skipskredittforeningen v. Emporor Navigation* (1997) CLC 1151, 1165.

<sup>35</sup> (1982) 1 All ER 634, 641.

annul the sale” could “have no operation where the description was to the knowledge of the vendor incorrect” in that it was “fraudulent.”<sup>36</sup>

According to Debattista, the principle of autonomy has been impaired by the Convention in two respects. From the point of view of unfair calls, the Convention renders it “more difficult for an unfair call to succeed.”<sup>37</sup> In determining whether a call is justified, sub-Articles 19(1)(b) and (c) and 19(2)(a), (b), (c) and (d) all require the issuer/principal to look to the underlying transaction for good cause for payment. Second, Debattista argues that “by repeatedly insisting on the exercise of good faith,” sub-Article 15(3), the tailpiece of sub-Article 19(1) and sub-Article (19)(2)(e), put both the beneficiary and the issuer/principal on notice that payment needs to be justifiable by good cause.<sup>38</sup>

*Sztejn v J Henry Schroder Banking Corporation*<sup>39</sup> is regarded as the leading case on the fraud exception to the autonomy principle,<sup>40</sup> although interestingly, the case proceeded on an underlying procedural assumption.<sup>41</sup>

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<sup>36</sup> See also *Thomas Witter v TBP Industries Ltd* (1996) 2 All ER 573.

<sup>37</sup> Charles Debattista, *Performance bonds: the ICC Rules and the UNCITRAL Convention*, 2 DOCUMENTARY CREDITS INSIGHT 4 (1996) (referring specifically to articles 15 and 19).

<sup>38</sup> *Id.*

<sup>39</sup> 31 N.Y.S.2d 631 (N.Y. App. Div. 1941).

<sup>40</sup> See generally, E.P. ELLINGER, DOCUMENTARY LETTERS OF CREDIT - A COMPARATIVE STUDY 190-196 (1970); JOHN F. DOLAN, THE LAW OF LETTERS OF CREDIT - COMMERCIAL AND STANDBY CREDITS 4.14-4.15 (2d ed. 1991); BROOKE WUNNICKE, ET AL., STANDBY AND COMMERCIAL LETTERS OF CREDIT 159-160 (1996); Adam Johnson and Daniel Aharoni, *Fraud and Discounted Deferred Payment Documentary Credits: The Banco Santander Case* 15 JIBL 22 (2000); Juliet May, *Letters of Credit - The Fraud Exception*, 3 Verulam Buildings Banking Law Newsletter (2000).

<sup>41</sup> The *Sztejn* case was a procedural matter, a motion by the defendant on the grounds that the facts did not disclose a cause of action. The court had to assume the facts to be true for the purpose of the hearing. This included the fact that the “Advising Bank” (the correspondent bank, namely Chartered Bank) was not a holder in due course. So whether or not it would be, or should be was not argued or examined. It may well be that the bank must be a holder in due course and that it should be paid as such notwithstanding the fraud. However, the matter remains moot and the case remains pivotal in letter of credit legal history and development. Justice Shientag noted, “For the purposes of this motion, the allegations of the complaint must be deemed established and ‘every intendment and fair inference is in favor of the pleading’ . . . it must be assumed that Transea was engaged in a scheme to defraud the plaintiff and Schwarz, that the merchandise shipped by Transea is worthless rubbish and that the Chartered Bank is not an innocent holder of the draft for



Chester Charles Szejn was a buyer based in the United States. He negotiated with Transea Traders Ltd., of Lucknow India, to purchase a quantity of hog bristles. Szejn applied for an irrevocable letter of credit to be issued by Schroder. Transea Traders Ltd. loaded fifty cases of material on board a steamship and secured a bill of lading and the usual invoices. The Chartered Bank located at Cawnpore, India, was the correspondent bank. Transea Traders Ltd. delivered the required documents to Chartered Bank. The crates were not filled with hog bristles, but with “cowhair, other worthless material, and rubbish.”<sup>42</sup> Prior to payment being made to the Chartered Bank by Schroder, Szejn applied for declaratory and injunctive relief.

Justice Shientag of the New York Supreme Court first restated the importance of the autonomy principle. His Honor considered the principle to be “well established” and that the Issuing Bank makes agreement “to pay upon presentation of documents, not goods.” Justice Shientag regarded the principle as “necessary to preserve the efficiency of the letter of credit as an instrument for the financing of trade.” His Honor prefaced the subsequent statements recognizing the fraud exception, by stating that any interference with the autonomy principle would be “most unfortunate” as it would impact on a chief purpose of the letter of credit to furnish the seller with prompt payment for the merchandise. His Honor expressed specific concern to protect business transactions and avoid going behind the documents or entering into controversies between the buyer and the seller regarding the quality of the merchandise shipped.<sup>43</sup>

Justice Shientag further distinguished the case before him as one involving fraud by the beneficiary and appropriately noted the case was not a mere breach of warranty. His Honor ruled that where the seller’s fraud has been called to the bank’s attention before the drafts and documents have

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value but is merely attempting to procure payment of the draft for Transea’s account.” *Szejn*, 31 N.Y.S.2d at 633.

<sup>42</sup> *Id.*

<sup>43</sup> *Id.*

been presented for payment, the autonomy principle<sup>44</sup> should not be extended to protect an unscrupulous seller.<sup>45</sup>

Although our courts have used broad language to the effect that a letter of credit is independent of the primary contract between the buyer and seller, that language was used in cases concerning alleged breaches of warranty; no case has been brought to my attention on this point involving an intentional fraud on the part of the seller which was brought to the bank's notice with the request that it withhold payment of the draft on this account. The distinction between a breach of warranty and active fraud on the part of the seller is supported by authority and reason.<sup>46</sup>

The Supreme Court of Canada in *Bank of Nova Scotia v Angelica-Whitewear Ltd.*<sup>47</sup> noted that the English and American decisions differed on the extent to which the fraud exception to the autonomy principle applied. In the English authorities, the letter of credit must be honored unless the beneficiary fraudulently presents false documents and the fraud is clearly established to the knowledge of the Issuing Bank at the time of the presentation of documents.<sup>48</sup> In the American authorities the principle has been expanded to include fraud in the underlying contract, for example where rubbish is delivered in place of the contract goods and the letter of credit is still called on. The Supreme Court of Canada agreed with the American approach that the fraud exception should extend to fraud in the underlying transaction. The court stated that the fraud exception applies in the underlying transaction where it is "of such a character as to make the demand for payment under the credit a fraudulent one."<sup>49</sup> In the court's

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<sup>44</sup> Justice Shientag uses the expression "principle of independence." *Id.* at 634.

<sup>45</sup> *Id.* Justice Shientag repeated his view on fraud as an exception in *Ashbury & Ocean Grove Park Bank v Nat'l City Bank of New York*, 35 N.Y.S. 2d. 985, 988 (N.Y. App. Div. 1942).

<sup>46</sup> *Id.* at 634-635.

<sup>47</sup> [1987] 36 D.L.R. 161 (Can.)

<sup>48</sup> For example see *Bank Russo-Iran v Gordan Woodroffe & Co.* (1972) The Times 4th Oct. (unreported) ("In my judgment, if the documents are presented by the beneficiary himself, and are forged or fraudulent, the bank is 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," per Browne LJ).

<sup>49</sup> *Angelica-Whitewear*, 36 D.L.R. at 176.

view “the fraud exception to the autonomy of a documentary credit should extend to any act of the beneficiary of a credit the effect of which would be to permit the beneficiary to obtain the benefit of the credit as a result of fraud.”<sup>50</sup>

By setting the standard and presenting examples, the Convention is able to redress the inadequacies of the rules of practice approach. The evolution of the customs and practice of letters of credit ignored the fraud exception. The UCP, URDG and ISP98 cannot define predetermined fraud standards whereby the guarantor or issuer is entitled to withhold payment. The UCP makes no attempt to deal with the fraud exception at all, leaving the matter to the courts. The ICC Banking Commission has debated the issue on several occasions and made the conscious choice to leave the matter to the courts.<sup>51</sup> The URDG similarly leaves the question of the fraud exception to the courts. The ISP98 expressly provides that it does not define or otherwise provide for defenses based on fraud, abuse, or similar matters and that these matters “are left to applicable law.”<sup>52</sup>

The UN Convention the drafters chose to avoid the term “fraud.” Instead, the Convention sets out categories of conduct and then the standards for obtaining court remedies.<sup>53</sup>

### Fraud

*Ex turpi causa non oritur actio*<sup>54</sup>

*Men were deceivers ever ...  
The fraud of men was ever so,  
Since summer first was leafy ...*<sup>55</sup>

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<sup>50</sup> *Id.* at 177.

<sup>51</sup> *Documentary Credits UCP 500 and 400 Compared*, International Chamber of Commerce [ICC] Publ'n No. 511, 2, 49 (Charles del Busto ed. 1993).

<sup>52</sup> *See The International Standby Practices 1998 (ISP98)*, R. 1.05, ICC Publ'n No. 590 (Jan. 1, 1999) [hereinafter ISP98].

<sup>53</sup> *See* The Convention, *supra* note 12, arts. 19, 20.

<sup>54</sup> *See* *Holman v. Johnson*, (1775) 98 Eng. Rep. 1120, 1121 (“from a dishonorable cause an action does not arise”).

<sup>55</sup> WILLIAM SHAKESPEARE, *MUCH ADO ABOUT NOTHING*, Act II, Scene III (A. Wilson Verity, ed., Rivingtons 1890) (1600).

The backbone of the letter of credit is the autonomy principle, dictating that banks deal with documents and are not concerned with nor bound by any underlying contract.<sup>56</sup> The doctrine of strict compliance compliments the autonomy principle providing the standard of compliance of the documents presented.

Nevertheless, banks face a dilemma when they receive a compliant presentation but conflicting pressure or instructions from the applicant not to honor that presentation. What is fraud? What should be a bank's response where the applicant, in all likelihood the issuing bank's customer, inform the bank of an irregularity in the underlying contract and instruct the bank not to honor the presentation? Assume further that the documents presented complied with the terms of the letter of credit. To what extent should it matter whether the complaint relates to quantity, such as a 1% or 10% shortfall, or the delivery of empty containers? Should the bank be concerned about the quality, such as an inferior but usable product, or perhaps complete rubbish? Should it matter to the bank whether the beneficiary was involved in these irregularities, knowing or otherwise? Does the doctrine of strict compliance require the bank to pay, thus

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<sup>56</sup> The principle is well established in common law, rules of practice and rules of law. For example, UCP600 Articles 4 and 5 contain the embodiment of this principle that credits are separate from the sales or other contracts on which they may be based: "4(a) A credit by its nature is a separate transaction from the sale or other contract on which it may be based. Banks are in no way concerned with or bound by such contract ... 5 Banks deal with documents and not with goods, services or performance to which the documents may relate." *The Uniform Customs and Practice for Documentary Credits (UCP600)*, ICC Publ'n No. 600 arts. 4, 5 (July 1, 2007). ISP98 provides "[a]n issuer's obligations toward the beneficiary are not affected by the issuer's rights and obligations toward the applicant under any applicable agreement, practice, or law." ISP98, *supra* note 52, R. 1.07. The Uniform Commercial Code provides that "[r]ights and obligations of an issuer to a beneficiary or a nominated person under a letter of credit are independent of the existence, performance, or non-performance of a contract or arrangement out of which the letter of credit arises" and "[a]n issuer is not responsible for ... the performance or non-performance of the underlying contract, arrangement, or transaction." U.C.C. §§ 5-103(d), 5-108(f) (1995). The UN Convention on Independent Guarantees and Standby Letters of Credit is headed "[i]ndependence of undertaking" and provides "an undertaking is independent where the guarantor/issuer's obligation to the beneficiary is not ... dependent upon the existence or validity of any underlying transaction, or upon any other undertaking ... ." The Convention, *supra* note 12, art. 3. The URDG provides that "(g)uarantees 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) ... ." *Uniform Rules for Demand Guarantees (URDG458)*, ICC Publ'n No. 458 art. 2(b) (1993).

rewarding the perpetrator and perhaps amounting to unjust enrichment? The answer to this last question must be emphatically in the negative.<sup>57</sup>

As early as 1765<sup>58</sup> the courts recognized the fraud exception to letters of credit. However, the value of a letter of credit as an instrument diminishes if the exception is used too readily or abused.<sup>59</sup> The courts have been sensitive to this concern and have kept the exception within certain bounds. Unfortunately, various jurisdictions have taken different approaches. The courts have used a broad spectrum of words to describe the level of fraud necessary to attract relief, such as: proven, gross, material, established, clearly established, outright, obvious, egregious, clear, of such a character, strong and prima facie, sufficient, sufficiently grave, intentional, active, actual and serious.

Fraud unravels all. This maxim is rooted in common law and equitable tradition. In the letter of credit case of *United City Merchants v. Royal Bank of Canada*<sup>60</sup> Lord Diplock stated:

The exception of 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 English is to be preferred, 'fraud unravels all.' The courts will not allow their process to be used by a dishonest person to carry out the fraud.

Fraud "vitiates everything" including judgments and orders of the court.<sup>61</sup> Where a transaction has been spoiled by fraud, that fraud will

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<sup>57</sup> See WUNNICKE ET AL., *supra* note 40, at 158.

<sup>58</sup> See *Pillans v. Van Mierop* (1765) 3 Burr 1663, 97 ER 1035.

<sup>59</sup> The autonomy principle and related doctrine of strict performance form the foundation of what makes the letter of credit a valuable commercial instrument. Lord Denning in *Power Curber Int'l Ltd. v Nat'l Bank of Kuwait* (1981) 1 WLR 1233 describes that value stating, "[i]t is vital that every bank which issues a letter of credit should honour its obligations. The bank is in no way concerned with any dispute that the buyer may have with the seller ... It ranks as cash and must be honoured." The purpose of utilizing banks is to secure mutual advantage to both parties to be of advantage to the seller to be given "what has been called in the authorities a 'reliable paymaster'" who can sue, and of advantage to the buyer in that he can make arrangement with his bankers. Justice McNair in *Soproma SpA v Marine & Animal By-Products Corp.* (1966) 1 Lloyd's Rep. 367, 385.

<sup>60</sup> (1983) 1 AC 168, 184.

<sup>61</sup> Denis Lane McDonnell and John George Monroe, *Kerr on the Law of Fraud and Mistake* 3 (7th ed. 1952).

continue to taint the transaction for as long as negotiations continue and into whatever ramifications it may extend.<sup>62</sup> The courts will prevent the fraudster and even innocent persons from deriving any benefit, unless such innocent persons have given consideration.<sup>63</sup> This approach is applicable to the letter of credit.<sup>64</sup>

The classic statement of fraud, from the common law world, comes from *Derry v. Peek*<sup>65</sup> that fraud exists “when it is shown that a false representation has been made (1) knowingly, or (2) without belief in its truth, or (3) recklessly, careless whether it be true or not.”<sup>66</sup> Fraud includes equitable fraud. In equity, the term “fraud” not only embraces actual fraud, but also other conduct that falls below the standard demanded in equity. There is no exhaustive definition of equitable fraud although the field is applicable to fields of undue influence and unconscionability.

In 1893 Lord Esher in *Leivre v Gould*<sup>67</sup> held “a charge of fraud is such a terrible thing to bring against a man that it cannot be maintained in Court unless it is shown he had a wicked mind.” Specifically, in letters of credit context, Ventris considers that an accusation of fraud “is one of the most serious which can be made in English litigation and has to be specially pleaded.”<sup>68</sup>

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<sup>62</sup> See *Reynell v. Sprye* (1852) 1 DM G 660, 697; *Smith v. Kay* (1859) 7 HLC 750, 775.

<sup>63</sup> See *Scholefield v. Templer* (1859) Johns 155, 4 D & J 429; *Tophamp v. Duke of Portland* (1863) 1 DJ & S 517, 569 per Turner LJ; *Morley v. Lougham* (1893) 1 Ch 736, 757; *Schneider v. Heath* (1813) 3 Camp 506; *Boyd v. Forest* (1911) SC 33, 61; *London and Gen. Omnibus Co. Ltd. v. Holloway* (1912) 2 KB 72, 81; and *Lazarus Estates Ltd. v. Beasley* (1956) 1 QB 702.

<sup>64</sup> See James E. Byrne, *Commercial Fraud: An Overview*, in 1996 ANNUAL SURVEY OF LETTER OF CREDIT LAW AND PRACTICE 34 (1997); and Joseph A. Colleran, *Letter of Credit Fraud -- Who Suffers? How Can it be Overcome?*, in 1996 ANNUAL SURVEY OF LETTER OF CREDIT LAW AND PRACTICE 40 (James Byrne ed., 1997).

<sup>65</sup> (1889) 14 App. Cas. 337, 374.

<sup>66</sup> In *Peek v. Gurney* (1873) LR 6 HL 377, 403 Lord Cairns considered that fraud existed where there was a partial statement of fact in such a manner that the withholding of what is not stated “makes that which is stated absolutely false.”

<sup>67</sup> [1893] 1 QB 491, 498.

<sup>68</sup> F.M. Ventris, *Bankers Documentary Credits* 155 (3d. ed. 1990).

These cases refer to the common law concept. Within the common law system, the distinction is made between common law fraud and equitable fraud. Fraudsters operate within all systems, for example tortious and criminal. In many civil law countries, the concept is known as Rechtsstaat. In the Chinese Rules on Letters of Credit, there were two separate Chinese words used, both of which loosely translated into the word "fraud." Both the common law lawyer and letter of credit lawyer would, on reading the English translation, be pleased with the use of the word "fraud," but could not be certain that the Chinese usage conveyed the same meaning.

### **Fraud as a Concept**

Much if not most of the success of the UCP is due to its ability to reflect the best banking practices rather than litigation inspired rules. The success of its remedy of strict preclusion is due to the underlying soundness of the practice of crediting and debiting accounts of correspondent banks. In contrast, the success of UCC Revised Article 5 and of the Convention depends upon the effectiveness of their remedies.

Few provisions of the Convention make substantive changes to the relatively acceptable level of custom, practice and interpretation currently experienced under the applicable international rules of practice for both independent guarantees and letters of credit. Central to the Convention's ideology is treatment given to allegations of fraud or abuse in demands for payment in undertakings. One stated main purpose of the Convention is to establish greater uniformity internationally in the manner in which guarantors, issuers and courts respond to allegations of fraud or abuse in demands.<sup>69</sup> Fraud has been a topic that has been "particularly troublesome and disruptive" in practice.<sup>70</sup> Notwithstanding numerous cases of actual fraud, often allegations of fraud are a fallback strategy for the guarantor or issuer where a dispute has arisen in the underlying contract. The differing approaches and interpretations taken by various jurisdictions complicate the area.<sup>71</sup> The official Explanatory Note to the Convention expresses this concern in the following terms:

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<sup>69</sup> See Explanatory Note, *supra* note 6, cmt. 45.

<sup>70</sup> *Id.*

<sup>71</sup> *Id.*

That difficulty and the resulting uncertainty have been compounded further because of the *divergent notions* and ways with which such allegations have been treated both by guarantor/issuers and by courts approached for provisional measures to block payment.<sup>72</sup>

Allegations of fraud and abusive demands threaten the integrity of the undertaking and jeopardize the commercial viability of the undertaking. The Convention aims to ameliorate the problem by the inclusion of circumstances in which courts may order that payment to be blocked. Although the word “fraud” is not used in the Convention, the exceptions to the payment obligation parallel the accepted fraud exception.<sup>73</sup>

The precise exceptions contained in Article 19 are designed to deal with specific instances and acts. Such an approach is to be welcomed considering the divergent opinions expressed by various jurisdictions.<sup>74</sup> The article encompasses fact patterns covered in different legal systems by notions such as “fraud” or “abuse of right.” The Convention deliberately avoids the use of the more nebulous term “fraud” and avoids the multiplicity of definitions, interpretations and complications inherent in the case law.

There are two circumstances in which the fraud exception may be relied upon. In the words of the Scottish Court of Sessions in *Royal Bank of Scotland v Holmes*:<sup>75</sup>

The authorities disclose two situations in which (the fraud exception) may be relied upon. It may be deployed in support of an application for interdict to prevent the bank from meeting a demand made by the beneficiary in the letter of credit or guarantee, where the bank’s customer is in a position to satisfy the court that there is a *prima facie* case that the beneficiary is acting fraudulently in making the claim, and that the balance of convenience favours *interim* interdict... The fraud exception may also be deployed as a defence to a claim for reimbursement by the

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<sup>72</sup> *Id.* (emphasis added).

<sup>73</sup> See The Convention, *supra* note 12, art. 19.

<sup>74</sup> See Explanatory Note, *supra* note 6, cmt. 45.

<sup>75</sup> (1999) Scot CS 10, 29, (1999) SLT 563.



bank against its customer in respect of sums paid in response to the demand of the beneficiary in the letter of credit or guarantee.

The latter situation arises where the confirming or issuing bank has decided that the material brought before it, otherwise in support of applying the fraud exception, was insufficient to withhold payment. Where the issuer wishes to avoid reimbursement to the bank, the issuer must show that a fraud has been committed by the beneficiary, and contrary to the bank's position, the material was sufficient evidence of fraud to justify the bank refusing payment.

The Convention appropriately refers only to the right of the guarantor/issuer to withhold payment. There is no need for the Convention, or any ancillary rules applicable to letters of credit or demand guarantees separately to deal with the second situation as enunciated in the *Holmes* case. Although there are no cases to date due to the recent and limited application of the Convention, where circumstances arise in which the guarantor/issuer declines to exercise the right, as granted by Article 19(1), the principal/applicant correspondingly would question why the guarantor/issuer failed to exercise the right. The contractual relationship between the principal/applicant and guarantor/issuer would impliedly, if not expressly, require the latter to act in good faith and in the best interests of the former. Whilst the guarantor/issuer has an obligation to the beneficiary to make payment on due presentment, this obligation is contemporaneous with the contractual obligation to the principal/applicant to act in the interests of the latter where fraud arises, or more specifically an Article 19(1) situation arises. Just as the guarantor/issuer should consider the position of the principal/applicant where discrepant documents are presented, the guarantor/issuer can be held contractually liable if the right to withhold payment is not exercised to the detriment of the principal/applicant.

Article 19(1) strikes a balance between the competing interests and considerations of the parties involved. The Explanatory Note to the Convention explicates that by giving the guarantor/issuer a right and not a duty and by requiring a good faith component, the Convention is "sensitive to the concern of guarantor/issuers over preserving the commercial reliability of undertakings as promises that are independent from underlying transactions."<sup>76</sup>

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<sup>76</sup> See Explanatory Note, *supra* note 6, cmt. 48.

The Convention does not annul any rights that the principal/applicant may have in accordance with its contractual relationship with the guarantor/issuer to avoid reimbursement of payment made in contravention of the terms of that contractual relationship.<sup>77</sup>

Where the right arises under article 19(1) the Convention affirms that the principal/applicant is entitled to provisional court measures to block payment. The level of fraud typically required for court intervention in similar circumstances under the UCP, ISP98 and URDG is fraught with inconsistent judgments and considerations. Article 20 spells out the circumstances, in which the parties agree to the issue of provisional court measures.<sup>78</sup>

The standard of proof is established in Article 20. Orders may be made where it is shown that there is a “high probability” of the Article 19(1) fraudulent or abusive circumstances “on the basis of immediately available strong evidence.” Additionally, the court must also consider whether the principal/applicant would be “likely to suffer serious harm” in the absence of the provisional measures. In this regard, the court may require the applicant for the order to furnish security. Notably, Article 20(3) adds that the provisional court orders blocking payment or freezing proceeds may also be made in the case of use of an undertaking for a criminal purpose.

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<sup>77</sup> *Id.* cmt. 49.

<sup>78</sup> Article 20 provides “(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.” The Convention, *supra* note 12, art. 20 (emphasis added).

### Balancing Competing Principles

The fraud exception has been fashioned even from the *Sztejn* decision, not to violate the autonomy principle. The courts have kept a balance between maintaining the integrity, certainty and stability of the letter of credit as an international tour de force, with ensuring that rogues do not profit from their actions and that the letter of credit is not used as a vehicle to facilitate fraud.<sup>79</sup>

In *Dynamics Corporation of America v Citizens & Southern National Bank*<sup>80</sup> the court, without coming to a conclusion, wrestled with the competing views of considering the plaintiff's "chance of winning this suit." "There is as much public interest in discouraging fraud as in encouraging the use of letters of credit."<sup>81</sup> Too few courts have recognized the need to balance the competing interests, in particular, appreciating the importance of maintaining the integrity and credibility of the letter of credit.

Bernard Wheble sardonically states: "(t)he way to avoid fraud is to avoid dealing with a rogue."<sup>82</sup> Wheble is referring to circumstances where fraud cannot be avoided. Leaving the matter purely to actions at law based on the underlying contracts will prove inadequate. Only attacking the disease at the root will accord a sense of justice. This has been recognized since at least *Derry v. Peek* and adopted and used by courts dealing with letter of credit issues.

In the context of the fraud exception, the UN Convention removes the uncertainties of terminology and provides a sound strategy and basis.

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<sup>79</sup> Hence the well respected statement, "[i]t is only in exceptional cases that the courts will interfere with the machinery of irrevocable obligations assumed by banks," made by Judge Kerr in *R D Harbottle (Mercantile) Ltd. v. National Westminster Bank Ltd.* (1977) 2 All ER 862, 870, (1977) 3 WLR 752, 761. See also Greg A. Fellingner, *Letters of Credit: The Autonomy Principle and the Fraud Exception*, 2 J. OF BANKING AND FIN. LAW, 4, 7 (1990) (concluding that "the utility of letters of credit in international transactions no longer presents a compelling rationale for upholding a strict autonomy rule"); and Nicholas Thodos, *Mareva Injunction, Attachment and the Independence Principle: Balancing the Interests*, 6 J. OF BANKING AND FIN. LAW AND PRAC. 101 (1995).

<sup>80</sup> 356 F. Supp. 991 (N.D. Ga. 1973).

<sup>81</sup> *Id.* at 1000.

<sup>82</sup> Bernard Wheble, ICC Publ'n No. 411, UCP 1974/1983 Revisions Compared and Explained (Documentary Credits) 15 (1984).

This assists banks and commercial parties in determining circumstances in which Articles 19 and 20 apply to know when payment ought to be withheld. When put to the test in litigation the Convention will succeed in its stated aim:

A main purpose of the Convention is to establish greater uniformity internationally in the manner in which guarantor/issuers and courts respond to allegations of fraud or abuse in demands for payment under independent guarantees and stand-by letters of credit.<sup>83</sup>

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<sup>83</sup> Explanatory Note, *supra* note 6, cmt. 45.

**The Fraud Rule under the UN Convention on Independent Guarantees  
and Standby Letters of Credit: A Significant Contribution from an  
International Perspective**

Xiang Gao\*

**Introduction**

Letters of credit are developed from international trade and have been said to be “the life blood of international commerce.”<sup>1</sup> Independent guarantees are synonyms of letters of credit in their legal nature. These instruments are widely used in varieties of international commercial transactions. Because of the highly international nature of letters of credit and independent guarantees, few individual countries in the world have introduced legislations governing them. Where there is any, so far with the exception of Article 5 of the Uniform Commercial Code (UCC) in the United States (US) and the *Rules of the Supreme People’s Court concerning Several Issues in Hearing Letter of Credit Cases*<sup>2</sup> (PRC LC Rules) in the People’s Republic of China (PRC), “it tends to consist of only a few provisions of a general nature.”<sup>3</sup>

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<sup>1</sup> R.D.Harbottle (Mercantile) Ltd. v. Nat’l Westminster Bank Ltd., (1978) 1 Q.B. 146, 155.

<sup>2</sup> The PRC LC Rules are a set of judicial interpretation. Judicial interpretations are made by the Supreme People’s Court of the PRC to provide practical guidance to all levels of courts in the PRC for the application of law with respect to a particular issue, a specific statute or an area of law if no statute exists therein. They are detailed, problem-solving orientated. Although they are not formally called as “law,” they are law in practical sense because they are cited in court decisions and legally effective. If there is no statute in an area, and a judicial interpretation has been made, that judicial interpretation has in fact become the only “law” in that area. The PRC LC Rules were promulgated by the Supreme People’s Court of the PRC in 2005 and became effective on January 1, 2006.

<sup>3</sup> The Secretary-General, Report of the Secretary General: Standby Letters of Credit and Guarantees, delivered to the Commission on International Trade Law, U.N. Doc. A/CN.9/301 (March 21, 1988).

The law of letters of credit has developed largely through customs of international trade.<sup>4</sup> Those customs have been mostly codified by the International Chamber of Commerce (ICC) in the *Uniform Customs and Practice for Documentary Credits* (UCP),<sup>5</sup> the *Uniform Rules for Contract Guarantees* (URCG),<sup>6</sup> the *Uniform Rules for Demand Guarantees* (URDG)<sup>7</sup> and the *International Standby Practices* (ISP98)<sup>8</sup>. Moreover, the United Nations Commission on International Trade Law (UNCITRAL) has introduced the *United Nation Convention on Independent Guarantees and Standby Letters of Credit* (the Convention).<sup>9</sup>

Letters of credit and independent guarantees are documentary transactions, which mean that what the presenter requiring payment under these instruments has to do is to produce documents on their face complying with the terms and conditions of the instrument. Because of their documentary nature, these instruments can be easily abused or are prone to the problem of fraud. As a result, over the years “a huge volume of case law concerning the issue of fraud has grown up. Legal writing on this topic is no

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<sup>4</sup> Boris Kozolchyk, *Letters of Credit*, 9 INT'L ENCYCLOPAEDIA OF COMPARATIVE LAW 10 (Jacob S. Ziegel ed., 1979).

<sup>5</sup> The UCP was first issued by the ICC in 1933 and has been revised six times ever since. The current version is known as “UCP600”, which was passed at the ICC Banking Commission meeting on October 25, 2006 and became effective on July 1, 2007. All texts referred to in this article are from UCP600, unless otherwise acknowledged. See *The Uniform Customs and Practice for Documentary Credits (UCP600)*, International Chamber of Commerce [ICC] Publ'n No. 600 (July 1, 2007) [hereinafter UCP600].

<sup>6</sup> *Uniform Rules for Contract Guarantees (URCG)*, ICC Publ'n No. 325 (1978).

<sup>7</sup> *Uniform Rules for Demand Guarantees (URDG458)*, ICC Publ'n No. 458 (1992). The URDG was recently revised effective after the date of drafting. All texts referred to in this article are from URDG458, unless otherwise acknowledged.

<sup>8</sup> *The International Standby Practices 1998 (ISP98)* ICC Publ'n No. 590 (Jan. 1, 1999) [hereinafter ISP98].

<sup>9</sup> United Nations Convention on Independent Guarantees and Stand-by Letters of Credit art. 5, Dec. 11, 1995, A/RES/50/48, available at <http://www.uncitral.org/pdf/english/texts/payments/guarantees/guarantees.pdf> [hereinafter The Convention]. As of 1 November 2010, eight nations have ratified or acceded to the Convention: Belarus, Ecuador, El Salvador, Gabon, Kuwait, Liberia, Panama and Tunisia. The United States of America has signed the Convention but has not yet ratified it or acceded to it. United Nations Treaty Status Database ch. X § 15, <http://treaties.un.org/doc/Publication/MTDSG/Volume%20I/Chapter%20X/X-15.en.pdf> (last visited Nov. 1, 2010).

less voluminous.”<sup>10</sup> In other words, the fraud rule has been a topic in the law of letters of credit and independent guarantees in practice. Nevertheless, in striking contrast to the practice, all the rules made by the ICC are silent or nearly silent with the issue of fraud. In the international level, only the Convention has made an effort to deal with the issue.

The purpose of this article to demonstrate and argue that the Convention has made a unique and significant contribution to the law of letters of credit and independent guarantees as a result of its position to the fraud rule at the international level. To facilitate the discussion, Part II will briefly introduce the mechanics of letters of credit and independent guarantees. Part III will provide a short summary about the development and the tenor of the fraud rule in the law of letters of credit at both the national and international level. Part IV will focus in detail on the provisions with regard to the fraud rule under the UN Convention. Part V concludes the article.

### **I. Mechanics of Letters of Credit and Independent Guarantees**

As mentioned, the letter of credit has been developed through international trade, so a simple example of international trade easily illustrates the operation of a letter of credit. Assume a seller in Shanghai wishes to sell TV sets to a buyer in New York. The seller and the buyer are strangers. The seller is worried that, if it delivers the goods first, the buyer may become insolvent or refuse to pay upon arrival of the goods. If the buyer does not pay, the seller will have to go to great expense to sue the buyer in a foreign jurisdiction, and may also have to incur the costs of disposing of the goods in an unfamiliar territory. In turn, the buyer is worried that it may not receive the goods if it pays the seller in advance. To assuage the parties' legitimate fears, they agree to conduct the transaction through a letter of credit, a smart merchant creature.

Under the letter of credit transaction, the buyer is normally required to procure an irrevocable letter of credit from a bank of good reputation. If the bank agrees to issue the letter of credit, it will be committed to honor a draft made by the seller upon its proper presentment of the draft accompanied by the documents specified in the letter of credit evidencing the seller's performance of the sales contract, which usually include a bill of lading – a document of title signifying the seller's ownership of the goods. The seller under such a transaction retains the ownership of the goods until it presents

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<sup>10</sup> ROELAND BERTRAMS, *BANK GUARANTEES IN INTERNATIONAL TRADE* 335 (3d. ed. 2004).

the documents to the bank, at which time it is either paid in the case of a sight draft, or promised to be paid at the maturity of the draft by the bank through its acceptance of the draft in the case of a time draft. The buyer knows that its money will not be paid to the seller unless the seller produces documents indicating that the goods have been shipped. The bank pays the seller for the buyer by taking security (a pledge) over the documents to secure the advance made financing the transaction.

This simple letter of credit transaction involves three parties: (1) the buyer, known as the applicant or the account party under the law of letter of credit; (2) the seller, known as the beneficiary; and (3) the bank, known as the issuer. It also involves three transactions: (1) the sales transaction, known as the underlying transaction between the buyer and the seller; (2) the transaction or the application agreement between the buyer and the bank; and (3) the transaction between the bank and the seller, which is the letter of credit itself.<sup>11</sup>

There are two fundamental principles under the law of letters of credit: the principle of independence and the principle of strict compliance. Under the former, the transactions under a letter of credit arrangement are separate and independent from each other,<sup>12</sup> and the letter of credit is a documentary transaction, under which “[b]anks deal with documents and not with goods, services or performance to which the documents may relate.”<sup>13</sup> The issuer is

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<sup>11</sup> In practice, more often than not, more parties and transactions are involved. For example, the issuing bank notifies the seller, usually through a correspondent bank in the seller's country. The correspondent bank may be instructed to act as an advising bank, which is a mere intermediary transmitting information, or to add to its own undertaking as a confirming bank, or to participate in the transaction as a negotiating bank by purchasing the drafts drawn by the beneficiary. Sometimes, a letter of credit transaction may only involve two parties. This kind of letter of credit is known as two-party letter of credit. For illustrations of two-party letters of credit, see Gerald T. McLaughlin, *Two Party Letters Of Credit: Two More Problems Than Three*, 4 J.B.F.L.P. 226 (1993); Gerald T. McLaughlin & Neil B. Cohen, *Commercial Law*, 9 N.Y.L.J. 3 (1993).

<sup>12</sup> UCP600, *supra* note 5, art. 4(a) (“A credit by its nature is a separate transaction from the sale or other contract on which it may be based. Banks are in no way concerned with or bound by such contract, even if any reference whatsoever to it is included in the credit. Consequently, the undertaking of a bank to honour, to negotiate or to fulfil any other obligation under the credit is not subject to claims or defences by the applicant resulting from its relationships with the issuing bank or the beneficiary. A beneficiary can in no case avail itself of the contractual relationships existing between banks or between the applicant and the issuing bank.”).

<sup>13</sup> *Id.* art. 5.



required to pay the beneficiary, irrespective of any disputes or claims relating to the underlying transaction between the beneficiary and the applicant.<sup>14</sup> The issuer is entitled to make the payment in good faith with full recourse against the applicant, even if the seller's documents turn out to be forgeries or fraudulent.<sup>15</sup> The issuer's only concern is whether the documents tendered conform on their face with the terms and conditions of the letter of credit.<sup>16</sup>

Under the principle of strict compliance, every party to a letter of credit transaction wishing to receive payment has to tender complying documents. If the documents tendered are on their face in strict compliance with the terms and conditions of the credit, the party who is obliged to honor the obligation under the letter of credit must take up the presentation and honor its obligation.<sup>17</sup> If the documents are not in compliance with the terms and conditions of the letters of credit, the beneficiary may not get paid even

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<sup>14</sup> *Hamzeh Malas & Sons v. British Imex Industrials Ltd.* (1958) 2 Q.B. 127, 129 ("it seems to be plain enough that the opening of a confirmed letter of credit constitutes a bargain between the banker and the vendor of the goods, which imposes upon the banker an absolute obligation to pay, irrespective of any dispute there may be between the parties as to 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."). *See also* Henry Harfield, *Quibbler's Corner*, *STANDBY AND COMMERCIAL LETTERS OF CREDIT* vi (2d. ed. 1996).

<sup>15</sup> UCP600, *supra* note 5, art. 34 ("A bank assumes no liability or responsibility for the form, sufficiency, accuracy, genuineness, falsification or legal effect of any document, or for the general or particular conditions stipulated in a document or superimposed thereon; nor does it assume any liability or responsibility for the description, quantity, weight, quality, condition, packing, delivery, value or existence of the goods, services or other performance represented by any document, or for the good faith or acts or omissions, solvency, performance or standing of the consignor, the carrier, the forwarder, the consignee or the insurer of the goods or any other person.").

<sup>16</sup> *Id.* art. 14(a) ("A nominated bank acting on its nomination, a confirming bank, if any, and the issuing bank must examine a presentation to determine, on the basis of the documents alone, whether or not the documents appear on their face to constitute a complying presentation.").

<sup>17</sup> *Id.* art. 15 ("(a) When an issuing bank determines that a presentation is complying, it must honour. (b) When a confirming bank determines that a presentation is complying, it must honour or negotiate and forward the documents to the issuing bank. (c) When a nominated bank determines that a presentation is complying and honours or negotiates, it must forward the documents to the confirming bank or issuing bank.").

though it has fully performed the underlying contract.<sup>18</sup>

Modern letters of credit are divided into two basic forms according to their distinctive commercial function and usage: commercial letters of credit and standby letters of credit. Commercial letters of credit are the traditional form of letters of credit created as a payment and mechanism for international sales of goods, as illustrated above. Standby letters of credit are used as a default instrument to provide security to the beneficiary against the (hopefully) unlikely contingency of the applicant's defective performance or non-performance of the underlying contract. For example, a US construction company contracts with the Iraqi Ministry of Oil (IMO) to build an oil pipeline in Iraq. To guarantee the US contractor's proper performance of the construction contract, the IMO requires the US contractor to provide a standby letter of credit in its favor. In case the US contractor defaults on the underlying construction contract, the IMO will present the required documents to the issuer of the standby letter of credit for payment. This demonstrates that a simple standby letter of credit transaction also involves three parties (the applicant, the issuer and the beneficiary) and three transactions (the underlying transaction, the application agreement and the letter of credit itself). Although the commercial function of standby letter of credit is different from that of commercial letters of credit, standby letters of credit operate legally in the same basic framework as commercial letters of credit.<sup>19</sup>

Standby letters of credit are used in a wide range of transactions. They are particularly used in industries like construction, finance and the

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<sup>18</sup> *Id.* art. 16 (a). When a nominated bank acting on its nomination, a confirming bank, if any, or the issuing bank determines that a presentation does not comply, it may refuse to honour or negotiate. However, discrepancies in the documents may be cured or waived. In 1987, a survey in the United States revealed that 90% of documents initially tendered contained discrepancies, but no more than 1% were incurable. *See* Boris Kozolchik, *Strict Compliance and the Reasonable Document Checker*, 56 BROOK. L. REV. 45, 48 (1990).

<sup>19</sup> James E. Byrne, ISP98, *supra* note 8, *Preface*.

international sales of goods.<sup>20</sup> In the words of Professor Dolan, “[t]here are virtually no limits to the variety of transactions that the standby credit can serve. In principle, standby credits can be used in any contract where the performance of one party is executory.”<sup>21</sup>

Independent guarantees<sup>22</sup> have similar commercial functions as standby letters of credit. That is to provide security against the possibility that some contingency may occur. A simple independent guarantee transaction has a similar mechanism to that of a letter of credit, involving three parties and

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<sup>20</sup> For more discussion on the use of standby letters of credit, see JOHN F. DOLAN, *THE LAW OF LETTERS OF CREDIT: COMMERCIAL AND STANDBY CREDITS*, 1, 1-24 (rev. ed. 2003 and 2006 Supplement No. 2, A.S. Pratt & Sons, 2006) (1984); Gordon B. Graham & Benjamin Geva, *Standby Credits in Canada*, 9 CAN. BUS. L.J. 180, 184 (1984); Cassondra E. Joseph, *Letters Of Credit: The Developing Concepts and Financing Functions*, 94 BANKING L.J. 816 (1977); Boris Kozolchyk, *The Financial Standby: A Summary Description of Practice and Related Legal Problems*, 28 UCC L.J. 327 (1996); Daniel E. Murray, *Letters of Credit in Nonsale of Goods Transactions*, 30 BUS LAW 1103 (1975); MICHAEL ROWE, *GUARANTEES, STANDBY LETTERS OF CREDIT AND OTHER SECURITIES* (1987); Reade H. Ryan, *Letters of Credit Supporting Debt for Borrowed Money: The Standby As Backup*, 100 BANKING L.J. 404 (1983).

<sup>21</sup> DOLAN, *supra* note 20, at 1-24. For a similar comment from another prominent letters of credit authority, see Boris Kozolchyk, *The Emerging Law of Standby Letters of Credit and Bank Guarantees*, 24 ARIZ. L. REV. 319, 320 (1982) (“the standby credit can encompass virtually every obligation known to man.”).

<sup>22</sup> This kind of guarantee has many other names: bank guarantee, first demand guarantee, independent guarantee, on-demand guarantee, performance guarantee, unconditional bond or performance bond. See Boris Kozolchyk, *Bank Guarantees and Letters of Credit: Time for a Return to the Fold*, 11 U. PA. J. INT’L BUS. L. 1, 13-14 (1989); UNCITRAL, Explanatory note by the UNCITRAL Secretariat on the United Nations Convention on Independent Guarantees and Stand-by Letters of Credit, n.8, U.N. Doc. A/CN.9/431 (July 4, 1996), available at <http://daccess-ods.un.org/TMP/9645256.html> [hereinafter Explanatory Note]. For a thorough treatment of independent guarantees, see BERTRAMS, *supra* note 10; Roy M. Goode, *The New ICC Uniform Rules Of Demand Guarantees*, LLOYD’S MAR. COM. L.Q. 190 (1992).

three transactions.<sup>23</sup> Independent guarantees legally stand “on a similar footing to a letter of credit,”<sup>24</sup> or “governed by the same principles as letters of credit.”<sup>25</sup> The two fundamental principles of letters of credit have been consistently applied to independent guarantees by the courts.<sup>26</sup> They share the same legal character of a letter of credit, in that the issuer’s obligation of payment is triggered simply by presentation by the beneficiary of complying documents or a simple demand, and the issuer/guarantor<sup>27</sup> is not concerned with whether there has been actual default by the principal. Therefore, standby letters of credit and independent guarantees are synonyms in law. They are all separate, independent and documentary undertakings in legal nature, and can be used interchangeably in practice.<sup>28</sup>

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<sup>23</sup> In practice, like commercial letters of credit, standby letters of credit and independent guarantees normally involve more than three parties and three transactions, and they can be used interchangeably. This can be illustrated by cases decided by US courts in relation to dealings between US companies and Iranian agencies following the Islamic Revolution (Iranian cases). In the Iranian cases, almost all transactions involved four parties—a US company, an Iranian agency, an Iranian bank, and a US Bank. The US company contracted with the Iranian agency to provide goods or services in Iran. The independent guarantees were issued by the Iranian bank and counter-guaranteed by standby letters of credit issued by the US bank in favour of the Iranian Bank at the request of the US company. In the event of a dispute the Iranian agency would demand payment under the guarantee from the Iranian bank, the Iranian bank would demand payment under the standby from the US bank, and the US bank would in turn look to the US company for reimbursement.

<sup>24</sup> See *Edward Owen Engineering Ltd. v. Barclays Bank Int'l Ltd.* (1978) 1 Q.B. 159, 170-171. See also *Bolivinter Oil SA v. Chase Manhattan Bank, (C.A.)* (1984) 1 Lloyd’s Rep. 251, 257; *Deutsche Ruckversicherung AG v. Walbrook Insurance Co. Ltd.* (1994) 4 All ER 181, 194; *RD Harbottle (Mercantile) Ltd. v. Nat'l Westminster Bank Ltd.* (1977) 2 All ER 862, 870.

<sup>25</sup> Agasha Mugasha, *THE LAW OF LETTERS OF CREDIT AND BANK GUARANTEES* 21 (The Federation Press 2003).

<sup>26</sup> See e.g., *Edward Owen Engineering Ltd. v. Barclays Bank Int'l Ltd.* (1978) 1 QB 159; *Howe Richardson Scale v. Polimex-Cekop* (1978) 1 Lloyd’s Rep. 161; *RD Harbottle (Mercantile) Ltd. v. Nat'l Westminster Bank Ltd.* (1977) 2 All ER 862.

<sup>27</sup> The terms used for the parties under independent guarantees are slightly different from those under letters of credit: the applicant or account party under a letter of credit is known as the instructing party, the principal or the account party under an independent guarantee; the issuer under a letter of credit is known as the guarantor under an independent guarantee; but the party in whose favor the letter of credit or independent guarantee is issued is known as the beneficiary under both of the instruments.

<sup>28</sup> While standby letters of credit are originated and widely used in the US, independent guarantees are commonly issued by European institutions. Both of them are interchangeably used in other regions. Cf. Mugasha, *supra* note 25, at 19-20.

Therefore, in this article, commercial letters of credit, standby letters of credit and independent guarantees are used interchangeably.

## II. The Development and Elements of the Fraud Rule

As has been illustrated, under the law of letters of credit, the beneficiary requiring payment does not have to show the issuer that it has properly performed its duties under the underlying transaction. All it needs to do is to produce documents on their face complying with the terms and conditions of the letter of credit. This leaves a loophole for unscrupulous beneficiaries to abuse the system and defraud the other parties involved. A simple example in a commercial letter of credit transaction would be a situation where the seller is paid by the issuer upon presenting documents complying on their face with all the requirements set out in the letter of credit, but the buyer does not receive the goods because the documents are in fact pure forgeries. An action by the applicant on the underlying contract against the beneficiary would normally be ineffectual as the fraudster would normally disappear in such a case. To prevent unfair situations as such from happening, the fraud rule has been developed.<sup>29</sup>

The fraud rule in the law of letters of credit is recognized as the exception to the principle of independence, allowing the issuer or the court to view the facts behind the face of conforming documents and disrupting payment of a letter of credit. Under the fraud rule, although documents presented are on their face in strict compliance with the terms and conditions of the letter of credit, payment may be stopped if fraud is found to have been committed in the transaction before payment is made, provided that the presenter does not belong to a protected class, such as a holder in due course.

### 1. The Catalyst: the *Sztejn* Case

The landmark case with regard to the development of the fraud rule in the law of letters of credit is *Sztejn v. J Henry Schroder Banking Corp*<sup>30</sup> in the US. In this case, *Sztejn* and others contracted to buy bristles from an Indian company and asked Schroder to issue a letter of credit in favor of the

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<sup>29</sup> Greg A. Fellingner, *Letters of Credit: the Autonomy Principle and the Fraud Exception*, 1 J. B.F.L.P. 4, 6 (1990).

<sup>30</sup> 31 N.Y.S. 2d 631 (N.Y. App. Div. 1941).

seller. The seller shipped fifty cases of “cowhair, other worthless material and rubbish,”<sup>31</sup> procured the documents required under the letter of credit and drew a draft to the order of Chartered Bank, which presented to Schroder for payment. Before payment was made, Sztejn filed a suit to prevent the issuer from paying the draft. Sztejn also claimed that the presenting bank was merely a collecting bank, not an innocent holder of the draft for value. The presenting bank moved to dismiss the complaint on the ground that it failed to state a cause of action because “the Chartered Bank is only concerned with the documents and on their face these conform to the requirements of the letter of credit.”<sup>32</sup>

Justice Shientag assumed that all allegations in the complaint were true, rejected the Chartered Bank’s motion and ruled for the plaintiff. In reaching his decision, Justice Shientag stated:

[W]here 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. ... On this motion only the complaint is before me and I am bound by its allegation that the Chartered Bank is not a holder in due course but is a mere agent for collection for the account of the seller charged with fraud. Therefore, the Chartered Bank's motion to dismiss the complaint must be denied. If it had appeared from the face of the complaint that the bank presenting the draft for payment was a holder in due course, its claim against the bank issuing the letter of credit would not be defeated even though the primary transaction was tainted with fraud.<sup>33</sup>

The *Sztejn* case has established three crucial elements of the fraud rule: 1) payment under a letter of credit can be stopped in a case of fraud; 2) payment under a letter of credit can only be stopped when fraud is established; and 3) payment should be made, notwithstanding the existence of proven fraud, if demand for payment is made by a holder in due course.

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<sup>31</sup> *Id.* at 633.

<sup>32</sup> *Id.* at 632.

<sup>33</sup> *Id.* at 634-635.

*Sztejn* has been cited by many courts with approval outside the US<sup>34</sup> and the fraud rule it established has been recognized worldwide.<sup>35</sup>

## 2. Article 5 of the UCC

The fraud rule manifested in the *Sztejn* case has been codified and fine-tuned in Article 5 of the UCC in the US.<sup>36</sup> Section 5-109 of Article 5 of the UCC reads:

- (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 honour of the presentation would facilitate a material fraud by the beneficiary on the issuer or applicant:
  - (1) the issuer shall honour the presentation, if honour 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 honoured 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 honour or dishonour the presentation in any other case.
- (b) If an applicant claims that a required document is forged or materially fraudulent or that honour of the presentation

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<sup>34</sup> For a UK case, see *United City Merchs. v. Royal Bank of Canada* (1979) 1 Lloyd's Rep. 267, (1981) 1 Lloyd's Rep. 604, (1983) A.C. 168. For an Australian case, see *Contronic Distribs. Pty. Ltd. v. Bank of New South Wales* (1984) 3 N.S.W.L.R. 110. For a Canadian case, see *Bank of Nova Scotia v. Angelica-Whitewear Ltd.* [1987] 36 D.L.R. 4th 161 (Can.).

<sup>35</sup> See BERTRAMS, *supra* note 10, at 335-447.

<sup>36</sup> Article 5 of the UCC was first issued in the 1950's and was revised in 1995. All texts referred to in this article are from the 1995 version.

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 honouring a presentation or grant similar relief against the issuer or other persons only if the courts find 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 honour does not qualify for protection under subsection (a)(1).

Section 5-109 of Article 5 of the UCC has restated the three basic elements of the fraud rule established by *Sztejn*: 1) payment can be stopped if fraud is involved in a letter of credit transaction; 2) payment under a letter of credit can only be stopped when fraud is established; and 3) payment should be made if demand is made by an innocent party such as a holder in due course. Moreover, section 5-109 of Article 5 of the UCC has improved the fraud rule in a number of respects. First, it clearly provides when fraud is found, payment of a letter of credit may be stopped by two ways: by the issuer's dishonor of the presentation<sup>37</sup> or by a court order to prevent payment by the issuer.<sup>38</sup> Secondly, it provides that the fraud rule can only be applied when "material" fraud is established,<sup>39</sup> setting up a clear standard

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<sup>37</sup> U.C.C. § 5-109(a)(2) (1995).

<sup>38</sup> *Id.* § 5-109(b).

<sup>39</sup> *Id.* § 5-109(a)-(b).



of fraud that can invoke the fraud rule.<sup>40</sup> Thirdly, it has listed four types of persons that may be immune from the fraud rule,<sup>41</sup> rather than one as indicated in *Sztejn*. Finally, it has stipulated four procedural conditions that must be met when a court considers an injunction.<sup>42</sup>

### 3. The PRC LC Rules

The PRC is the only other country, apart from the US, which has issued a full set of rules with regard to letters of credit. The fraud rule is the major focus of the PRC LC Rules. There are altogether eighteen articles in the PRC LC Rules, eight of which are devoted to the fraud rule. Having learned from the court practices of other jurisdictions, the provisions of Article 5 of the UCC and the Convention,<sup>43</sup> and having taken into consideration of the special nature of letters of credit and the practice of the Chinese courts in the past, the drafters of the PRC LC Rules have tried to make the rules as detailed and comprehensive as possible, covering both substantive and procedural matters of the law.<sup>44</sup>

Article 8 of the PRC LC Rules has first provided the type or the standard of fraud that can invoke the fraud rule by introducing the concept of “letter of credit fraud” to indicate that the fraud in the law of letters of credit is not entirely as the same as in general civil and commercial cases. Having in particular learned from Article 19 of the Convention, Article 8 of the PRC LC Rules has named four types of situations that can invoke the fraud rule, namely:

- (1) The beneficiary has forged documents or presented documents containing fraudulent information;

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<sup>40</sup> The standard of fraud has proven to be the most controversial issue in the application of the fraud rule. For a detailed treatment of the issue, see Xiang Gao & Ross Buckley, *A Comparative Analysis of the Standard of Fraud Required under the Fraud Rule in Letter of Credit Law*, 12 DUKE J. COMP. & INT'L L. 293 (2003).

<sup>41</sup> U.C.C. § 5-109(a)(1) (1995).

<sup>42</sup> *Id.* § 5-109(b).

<sup>43</sup> For details, see *infra* Part IV.

<sup>44</sup> For a thorough treatment of the PRC LC Rules, see Xiang Gao, *Fraud Rule in the Law of Letters of Credit in the PRC*, 41 INT'L LAW. 1067 (2007).

- (2) The beneficiary has intentionally failed to deliver goods or delivered goods with no value;
- (3) The beneficiary has conspired with the applicant or a third party and presented fraudulent documents whereas there is no actual underlying transaction; or
- (4) Other circumstances that constitute letter of credit fraud.

Similar to section 5-109(a)(1) of Article 5 of the UCC, Article 10 of the PRC LC Rules has named four types of situations in which the fraud rule cannot be applied, even if fraud is established in a letter of credit transaction. They are:

- (1) The nominated person or the person authorised by the issuing bank has paid in good faith in accordance with the instructions of the issuing bank;
- (2) The issuing bank or its nominated or authorized person has accepted the draft under the letter of credit in good faith;
- (3) The confirming bank has paid in good faith; or
- (4) The negotiation bank has negotiated in good faith.

The other six articles of the PRC LC Rules are all related to procedural matters. Among them, Articles 9 and 11 are the most important. Article 9 provides who can take a court action to prevent payment under the letter of credit, saying that “[t]he applicant, the issuing bank or any other interested party may apply to a competent people’s court for a ruling to suspend the payment ... .” Similar to section 5-109(b) of Article 5 of the UCC and Article 20 of the Convention, Article 11 of the PRC LC Rules has specified procedural conditions that must be met when a court considers measures to stop payment of a letter of credit, providing:

- (1) The people’s court receiving the application has the competent jurisdiction over the case;
- (2) The evidence rendered by the applicant has established the existence of the circumstances set out in Article 8 hereinbefore;
- (3) The applicant will suffer irreparable damage if a ruling to suspend the payment is not issued;

- (4) The applicant has provided effective and adequate security; and
- (5) The circumstances set out in Article 10 hereinbefore do not exist.

In particular, it is worthwhile to point out that, under Article 11(2) of the PRC LC rules, the fraud rule can only be applied when fraud is “established.”

#### 4. The ICC Rules

##### A. Uniform Customs and Practice (UCP)

The UCP is a compilation of internationally accepted banking customs and practice regarding letters of credit. It is the most successful harmonizing measure in the history of international commerce.<sup>45</sup> It is “the cornerstone of the law pertaining to letters of credit.”<sup>46</sup> It is virtually incorporated into every letter of credit.<sup>47</sup> However, the UCP is silent with respect to the fraud rule. “Both the content and the interpretation of the ICC uniform rules are influenced by the fact that their function is to serve as rules of best banking practice, not rules of law.”<sup>48</sup> As the fraud issue is traditionally considered as the province of the applicable law and of the courts of the forum,<sup>49</sup> the drafters of the UCP, who are aware of the fraud issue,<sup>50</sup> have deliberately left it out.<sup>51</sup>

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<sup>45</sup> Goode, *supra* note 22, at 190.

<sup>46</sup> E.P. Ellinger, *The Uniform Customs—Their Nature and the 1983 Revision*, (1984) L.M.C.L.Q. 578, 578. See e.g., James G. Barnes, *Internationalisation of Revised UCC Article 5 (Letters of Credit)*, 16 NW. J. INT’L L. & BUS. 215, 216 (1995) (“The UCP ... is incorporated into substantially all across-border commercial letters of credit, studied and observed by letter of credit bankers and users worldwide, and treated as quasi-law.”).

<sup>47</sup> S. Isabella Chung, *Developing a Documentary Credit Dispute Resolution System: An ICC Perspective*, 19 FORDHAM INT’L L.J. 1349, 1355 (1996); DOLAN, *supra* note 20, at 6-2; Ellinger, *supra* note 46, at 583.

<sup>48</sup> Roy M. Goode, *Abstract Payment Undertakings and the Rules of the International Chamber of Commerce*, 39 ST. LOUIS U. L.J. 725, 727 (1995).

<sup>49</sup> Ross P. Buckley, *1993 Revision of the Uniform Customs and Practice for Document Credit*, 28 GEO. WASH. J. INT’L & ECON. 266, 302-3 (1995).

<sup>50</sup> John F. Dolan, *Commentary on Legislative Developments in Letters of Credit Law: An Interim Report*, 8 B.F.L.R. 53, 63 (1992).

## B. Uniform Rules for Contract Guarantees (URCG)

The URCG was published by the ICC in 1978.<sup>52</sup> The purpose of the URCG was to respond to the need for a set of standard rules to deal with ambiguities or inconsistencies in the field of “[g]uarantees given by banks, insurance companies and other guarantors in the form of tender bonds, performance guarantees and repayment guarantees in relation to projects in another country involving the supply of goods or services or the performance of work.”<sup>53</sup> Unlike the UCP, the URCG has attempted to tackle the issue of fraud in the context “unfair calling” of independent guarantees in some extent. Article 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 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 approval

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<sup>51</sup> Katherine A. Barski, *Letters of Credit: A Comparison of Article 5 of the Uniform Commercial Code and the Uniform Customs and Practice for Documentary Credits*, 41 LOY. L. REV. 735, 751 (1996).

<sup>52</sup> See URCG, *supra* note 6.

<sup>53</sup> *Id.* at 7; Cf. James E. Byrne, *Fundamental Issues in the Unification and Harmonisation of Letter of Credit Law*, 37 LOY. L. REV. 1, 4 (1991).

of the principal in writing to the claim and the amount to be paid.

The URCG has rarely been used in practice since its publication.<sup>54</sup> It has been said that the major hurdle to the acceptance of the URCG is its requirement of “the production of a judgment or arbitral award or the principal’s written approval of the claim and its amount”<sup>55</sup> as a condition for the beneficiary to obtain payment. Strictly speaking, provisions of Article 9 of the URCG are not the same as the fraud rule under discussion. The fraud rule is concerned with the circumstances under which payment of a letter of credit or independent guarantee can be disrupted. Article 9 of the URCG provides the conditions that trigger the payment of independent guarantees.

### C. Uniform Rule for Demand Guarantees (URDG)

As the URCG was rarely accepted and used in the market, the ICC decided to replace it with a new set of rules with regard to independent guarantees. The URDG takes a similar position to the UCP on the issue of fraud —basically to be silent and leave it to the courts of the various jurisdictions. It merely implicitly goes some small way towards putting restrictions on the beneficiary’s right of payment in Article 20 in order to prevent the beneficiary’s outright unjustified calling, saying:

- 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 tender guarantee, the tender conditions; and
  - (ii) the respect in which the Principal is in breach.

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<sup>54</sup> Filip De Ly, *The UN Convention on Independent Guarantees and Standby Letters of Credit*, 33 INT’L LAW. 831, 835 (1999).

<sup>55</sup> Roy M. Goode, *Guide To The ICC Uniform Rules For Demand Guarantees*, ICC Publ’n No. 510, 6 (1992).

- 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.

Article 20 of the URDG requires the beneficiary demanding payment to state in writing both that there is some kind of breach of the underlying transaction and what type of breach is involved, thus giving the other parties some kind of protection by providing a ground for a claim of fraud. However, this provision is similar to Article 9 of the URDG, providing a kind of safety device for the trigger of the payment of the independent guarantee to prevent fraud, but differs from the fraud rule under discussion, which addresses what to do when fraud is found to have been committed.

#### **D. International Standby Practices (ISP98)**

The ISP98 is “specifically designed for standby letters of credit.”<sup>56</sup> It takes a similar approach to the UCP and expressly leaves the issue of fraudulent or abusive drawing or “defenses to honour based on fraud, abuse or similar matters ... to applicable law.”<sup>57</sup> Under Rules 4.16 and 4.17 of the ISP98, a demand for payment under a standby letter of credit is not required to indicate a default or other event in the underlying transaction if that is not required under the terms and conditions of the standby letter of credit. Therefore, it is even a step back from the position of the URDG, where the beneficiary is required to state that there is a breach of the underlying transaction and what type of breach is involved.

### **5. The United Nations Convention on Independent Guarantees and Stand-by Letters of Credit (The Convention)**

The Convention was adopted by the General Assembly of the United

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<sup>56</sup> James E. Byrne, *The International Standby Practices (ISP98): New Rules for Standby Letters of Credit*, 32 UCC L.J. 149, 151 (1999).

<sup>57</sup> ISP98, *supra* note 8, R. 1.05.

Nations on December 11, 1995.<sup>58</sup> As of 1 April 2009, the UN Convention has been signed by nine countries and ratified by eight of them.<sup>59</sup> It came into force on January 1, 2000.<sup>60</sup>

The Convention applies to “an international undertaking”<sup>61</sup> such as an independent guarantee or a standby letters of credit,<sup>62</sup> where “the place of business of the guarantor/issuer at which the undertaking is issued is in a Contracting State”<sup>63</sup> or “the rules of private law lead to the application of the law of a Contracting State, unless the undertaking excludes the application of the Convention.”<sup>64</sup> The Convention can also apply to commercial letters of credit if the parties expressly state that their credit is

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<sup>58</sup> See Explanatory Note, *supra* note 22, cmt. 6. See also UNCITRAL, <http://www.uncitral.org/uncitral/en/uncitraltexts/payments/1995Conventionguaranteescredit.html> (last visited Nov. 15, 2010). For further literature concerning the Convention, see Roger Fayers, *The latest UNCITRAL text raises some intriguing questions about the relationship of the Convention/Model Law with the UCP*, DOCUMENTARY CREDITS INSIGHT, Spring 1995, at 22-23; Eric E. Bergsten, *A New Regime for International Independent Guarantees and Stand-By Letters of Credit: The UNCITRAL Draft Convention on Guaranty Letters*, 27 INT'L LAW., 859-879 (1993); Henry Harfield, *Guaranties, Stand-by Letters of Credit and Ugly Ducklings*, 26 UCC L.J. 195-203 (1994); Glower W. Jones, *UNCITRAL Draft Convention on International Guaranty Letters*, INT'L BUS. LAW. 28-34 (1994); James E. Byrne & Harold Burman, *Introductory Note, United Nations Convention on Independent Guarantees and Stand-by Letters of Credit*, 35 I.L.M. 735-738 (1996); Lars Gorton, *Draft UNCITRAL Convention on Independent Guarantees*, 1997 J. BUS. L. 240-253; John Dolan, *The UN Convention on International Independent Undertakings: Do States with Mature Letter-of-Credit Regimes Need It?*, 13 BANKING & FINANCE L. REV. 1-23 (1998); De Ly, *supra* note 50.

<sup>59</sup> See UNCITRAL, [http://www.uncitral.org/uncitral/en/uncitral/texts/payments/1995Convention\\_guarantees/status.html](http://www.uncitral.org/uncitral/en/uncitral/texts/payments/1995Convention_guarantees/status.html) (last visited on Nov. 15, 2010).

<sup>60</sup> The Convention, *supra* note 9, art. 28. In accordance with Article 28 of the UN Convention, it will enter into force on the first day of the month following the expiration of one year from the deposit of the fifth instrument of ratification. Because Tunisia, the fifth state, deposited its ratification on December 8, 1998, it came into force on the date mentioned here.

<sup>61</sup> *Id.* art. 1(1). For the meaning of the internationality of the undertaking, see The Convention, *supra* note 9, art. 4.

<sup>62</sup> *Id.* art. 2(1).

<sup>63</sup> *Id.* art. 1(1)(a).

<sup>64</sup> *Id.* art. 1(1)(b).

subject to it.<sup>65</sup>

The Convention is basically modelled upon both the UCP and the URDG, but it is distinctive in that both the UCP and the URDG are drafted by the ICC, a non-government organization,<sup>66</sup> as voluntary rules or self regulation, whereas the Convention is drafted by the UNCITRAL, as a uniform law or official regulation<sup>67</sup> for those countries who adopt it. As a result, the Convention, “[i]n addition to being essentially consistent with the solutions found in the rules of practice, ... supplements their operation by dealing with issues beyond the scope of such rules. It does so in particular regarding the question of fraudulent or abusive demands for payment and judicial remedies in such instances.”<sup>68</sup> In other words, it has provisions with respect to the fraud rule. To void repetition and segmentation, the articles will be listed in Part IV below.

### III. Commentary on the Fraud Rule under the Convention

There are altogether three articles related to the fraud rule under the Convention. They are Articles 15, 19 and 20. In Article 15(3), the Convention first sets up a general requirement for the beneficiary demanding payment under a letter of credit or independent guarantee, providing:

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.

This looks similar to Article 9 of the URDG and Article 20 of the URDG, providing a kind of safety device for the trigger of the payment of the instrument to prevent fraud, and differs from the fraud rule. However, unlike those provisions under the URDG and the URDG, Article 15(3) of the Convention does not only require the beneficiary to be “not in bad faith”

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<sup>65</sup> *Id.* art. 1(2). See Gorton, *supra* note 58, at 244 n.11 (“Some voices were raised to expand the Convention to also cover documentary credits generally, but they were in a very clear minority.”).

<sup>66</sup> See ICC, <http://www.iccwbo.org/id93/index.html> (last accessed Nov. 15, 2010).

<sup>67</sup> De Ly, *supra* note 54, at 835.

<sup>68</sup> Explanatory Note, *supra* note 22, cmt. 5.



when making a demand for payment, but also implies that payment has the potential to be disrupted if the elements listed in Article 19 exist in the demand. Following it, Article 19 of the Convention, with the heading of "Exception to payment obligation," provides:

- (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 satisfaction of the beneficiary;
  - (d) Fulfilment of the underlying obligation has clearly been prevented by wilful misconduct of the beneficiary;
  - (e) 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.

As can be seen, Article 19 of the Convention has clearly covered the substantive elements of the fraud rule. It first sets out the test of proof or the standard of fraud by providing that the fraud rule can only be applied when “manifest and clear” fraud is involved. This is the most important and controversial issue under the fraud rule of the letter of credit. It is important because the fraud rule is applied when fraud is found in the transaction. To apply the fraud rule, the first and foremost important question for courts hearing letter of credit fraud cases to decide is what is fraud under the law of letters of credit or what kind of fraud can invoke the fraud rule. It is controversial because fraud is an “inherently pliable concept”<sup>69</sup> and very hard to be defined. Some take the view that the fraud rule must be applied in a strict fashion, or in cases where only “egregious” fraud is involved.<sup>70</sup> Others favor a more flexible approach to the concept.<sup>71</sup> By requiring the “manifest and clear” standard, Article 19 of the Convention has set up a narrow and high standard for the application of the fraud rule. Further, instead of providing a general standard of fraud as what has been done in Article 5 of the UCC, Article 19(1) of the Convention has listed three

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<sup>69</sup> Gerald T. McLaughlin, *Letters Of Credit and Illegal Contracts: The Limits of the Independence Principle*, 49 OHIO ST. L. J. 1197, 1203 (1989).

<sup>70</sup> *E.g.*, N.Y. Life Ins. Co. v. Hartford Nat. Bank & Trust Co., 378 A. 2d 562, 567 (1977) (“Only in rare situations of egregious fraud would § 5-114 have justified the issuer, on the facts presented here, in going behind apparently regular, conforming documents; such fraud ‘must be narrowly limited to situations ... 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.’”) (citing *Intraworld Indus., Inc. v. Girard Trust Bank*, 461 Pa. 343, 336 A. 2d 316, 342-325 (1975)). *See also* Henry Harfield, *Enjoining Letter of Credit Transactions*, 95 BANKING L.J. 596, 603 (1978).

<sup>71</sup> *E.g.*, *Dynamics Corp. of Amer. v. Citizens & Southern Nat. Bank*, 356 F. Supp. 991, 998-999 (1973) (“The law of ‘fraud’ is not static and the courts have, over the years, adapted it to the changing nature of commercial transactions in our society ... [I]n a suit for equitable relief—such as this one—it is not necessary that plaintiff establish all the elements of actionable fraud required in a suit for monetary damages ... ‘Fraud has a broader meaning in equity [than at law] [sic] and intention to defraud or to misrepresent is not a necessary element. Fraud, indeed, in the sense of a court of equity properly includes all acts, omissions and concealments which involve a breach of legal or equitable duty, trust, or confidence, justly reposed, and are injurious to another, or by which an undue and unconscious advantage is taken of another.’”) (citing *SEC v. Capital Gains Research Bureau Inc.*, 375 U.S. 180, 193-94 (1963)).

particular situations that can invoke the fraud rule, which is similar to, and has influenced of the formation, the provisions of Article 8 of the PRC LC Rules.

In addition, to assist courts and other parties in determining the existence of fraud, Article 19(2) of the Convention has provided five situations to explain what “no conceivable basis” mean in Article 19(1)(c). This list may not be exhaustive, but it is an impressive and encouraging way in which to define the kind of misconduct that can invoke the fraud rule. It undoubtedly stands as the most detailed provision so far as to the clarification of the misconduct that may bring the fraud rule into play. These provisions are “clear and narrow in scope and provide an excellent international standard.”<sup>72</sup> They will undoubtedly provide good guidance for courts to enhance their application of the fraud rule.

Finally, Article 19 of the Convention sets out what actions can be taken when “manifest and clear” fraud is involved in the transaction: (1) the issuer or guarantor can dishonor the presentation;<sup>73</sup> and (2) the applicant or principal can bring a court action to prevent the payment in accordance with Article 20 of the Convention if the issuer or guarantor is not prepared to dishonor,<sup>74</sup> which is similar to the format provided in s 5-109(b) of Article 5 of the UCC in the US. Then, in Article 20, the Convention, with the heading of “Provisional court measures,” provides:

- (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

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<sup>72</sup> *Litigation Digest: Agritrade International Pte Ltd v Industrial and Commercial Bank of China [1998] 3 SLR [Singapore] 4 (3) DOCUMENTARY CREDIT WORLD 8, 13 (2000).*

<sup>73</sup> The Convention, *supra* note 9, art. 19(1). Since Article 19(1) of the Convention does not use the word “may” as does in Article 5 of the U.C.C. in the United States, some commentators have suggested that it implies certain duties on the issuer to make a judgment whether the demand for payment is warranted. *See Gorton supra* note 58, at 249. However, it seems that this interpretation is a bit too narrow, as the Article only says that the issuer/guarantor “has a right” to withhold or refuse payment, which does not mean that it must exercise that right. Due to the nature of letters of credit, the issuer should not be obliged to consider whether the demand is justified or not, but be allowed a discretion for honour or dishonour when payment is demanded.

<sup>74</sup> The Convention, *supra* note 9, art. 19(3).

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.

Article 20 of the Convention is similar to section 5-109(b) of Article 5 of the UCC, spelling out the procedural matters of the law when remedies are sought from courts as a result of fraud in a letter of credit transaction. As suggested by the heading, Article 20 of the Convention states that “provisional rather than conservatory measures are intended.”<sup>75</sup> With regard to provisional measures, the Convention is “strict enough with account parties while still being flexible enough to permit the application of provisional measures in exceptional cases.”<sup>76</sup>

The provisions of the Convention with regard to the fraud rule are by and large in accordance with current practice. They include most of the elements of the fraud rule that have been developed over the years by national courts and/or legislators and provide a detailed and helpful guide to users of letters of credit and the courts except one critical point: having failed to mention who should be immune from the fraud rule.

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<sup>75</sup> De Ly, *supra* note 54, at 843.

<sup>76</sup> *Id.* at 842.

#### IV. Conclusion

Letters of credit are products of international trade. Fraud in transactions of letters of credit and independent guarantees can be found anywhere across the globe. Therefore, dealing with fraud in transactions of letters of credit and independent guarantees are similar to dealing with the current financial global crisis: a unified global approach is needed.

However, through the examination of the law of letters of credit and independent guarantees at the national and international level, it has been revealed that currently the fraud rule has been provided in both the US and the PRC, the only two countries in the world having a detailed set of law with regard to letters of credit so far. However, at the international level, only the Convention has made an effort to address the issue of fraud. All the rules made by the ICC are silent or nearly silent with the issue, which is disappointing and puzzling.

Good commercial laws are those that can serve commerce best. Laws that can serve commerce best are those that can maximise certainty and predictability for the commercial community. To have such an effect, a law should give the best answers it can give to the problems that are predicted. It is questionable whether the rules made by the ICC can satisfy this standard without dealing with the fraud issue. The drafters of the rules of the ICC knew of the problem of fraud, but they chose not to address it, leaving users of letters of credit to national laws, laws which letter of credit users often have no familiarity with. To make matters worse, national laws are diverse and lacking clarity. Moreover, the law of letters of credit is a commercial specialty and complex. Even letter of credit specialists are sometimes perplexed by its complicated structure. Judges should be legal experts, but it is not practical to expect every judge to be an expert in the law of the letter of credit or to make good law within the short framework of time that a case is before it. The reality is that “[m]ost trial judges have had little experience with letter of credit matters.”<sup>77</sup> Under such an environment, when a fraud case of letter of credit goes to a court and a decision is made, that decision is often criticised by letter of credit experts for not having followed the practice of the letter of credit community or for being detrimental to the commercial utility of letters of credit.<sup>78</sup>

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<sup>77</sup> James E. Byrne, et al., *An Examination of UCC Article 5 (Letters of Credit)*, 45 BUS. LAW. 1521, 1611 (1990).

<sup>78</sup> For example, the decisions of the Chinese courts were often the target of this kind of criticism before the PRC LC Rules were promulgated. See XIANG GAO, THE FRAUD RULE

Therefore, it is surely desirable for the drafters of the ICC rules of letters of credit and independent guarantees, well-known experts in the area, to address the issues known in practice, including fraud.<sup>79</sup> If a detailed set of rules is not practical, a simple guidance is better than nothing. In this respect, the Convention has sets a good example and made a unique and significant contribution to the development of the fraud rule and the law of letters of credit and independent guarantees as a whole from the international prospective. The “provisions constitute a good barometer of international consensus on the topic of fraud.”<sup>80</sup>

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IN THE LAW OF LETTERS OF CREDIT, A COMPARATIVE STUDY, 173-174 (Klumer Law Int'l 2002).

<sup>79</sup> Cf. Clive M. Schmitthoff, *Export Trade*, in J.BUS. L. 319, 321 (1982).

<sup>80</sup> Mugasha, *supra* note 25, at 138.

## **International Measures to Prohibit Fraudulent Calls on Demand Guarantees and Standby Letters of Credit**

Michelle Kelly-Louw\*

### **Introduction**

It is common practice for many buyers, in particular foreign buyers, to demand that sellers, exporters or suppliers provide bank demand guarantees or standby letters of credit as security to ensure that the terms of their tender or contract (depending on the circumstances) are adhered to. Bank demand guarantees and standby letters of credit have become an established part of international trade, particularly in construction and engineering projects, and international sale of goods contracts.

Demand guarantees and standby letters of credit imply the danger that they may be abused. In fact, in the past few decades many cases in various countries have been brought before the courts where a party to, for example, an export transaction has complained that the other party has used the demand guarantee or standby letter of credit contrary to its purpose; in other words, tried to collect money under the guarantee or standby letter of credit in an unjustified or fraudulent way.<sup>1</sup> An abuse of a demand guarantee/standby letter of credit can be described as a case where the risk covered by that guarantee/standby letter of credit has not materialised and payment is demanded without justification.

The International Chamber of Commerce (ICC) and the United Nations Commission on International Trade Law (UNCITRAL) have both been active in seeking a solution to the problems caused by unfair or fraudulent calls on demand guarantees and standby letters of credit. Four instruments that are particularly relevant are (1) the ICC Uniform Rules for Contract Guarantees (URCG);<sup>2</sup> (2) the ICC Uniform Rules for Demand

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<sup>1</sup> See Ross P. Buckley & Gao Xiang, *The Development of the Fraud Rule in Letter of Credit Law; The Journey So Far and the Road Ahead*, 23 U. PA. J. INT'L ECON. L. 663, 688-99 (2002).

<sup>2</sup> *Uniform Rules for Contract Guarantees (URCG)*, International Chamber of Commerce [ICC] Publ'n No. 325 (1978) [hereinafter URCG].

Guarantees (URDG458);<sup>3</sup> (3) the International Standby Practices (ISP98);<sup>4</sup> and (4) the United Nations Convention on Independent Guarantees and the Stand-by Letters of Credit (the Convention).<sup>5</sup> The first three instruments of the ICC are, in effect, standard-term contract rules available for incorporation into demand guarantees and standby letters of credit by the parties if they so choose. The adoption of the Convention by a state has the effect of making it law in that state.<sup>6</sup>

In this article particular attention will be paid to the international attempts made by the ICC and UNCITRAL to prevent unfair or fraudulent calls on demand guarantees and standby letters of credit. Attention will also be given the ICC's Uniform Customs and Practice for Documentary Credits (2007 version) (UCP600)<sup>7</sup> and their predecessor, the Uniform Customs and Practice for Documentary Credits (1993 version) (UCP500)<sup>8</sup> neither of which contain provisions attempting to prevent unfair or fraudulent demands being made on commercial or standby letters of credit. The article also examines which of the ICC instruments and the Convention departs the furthest from the principle of autonomy in the context of demand guarantees and standby letters of credit. Broadly speaking, the URDG and the

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<sup>3</sup> *Uniform Rules for Demand Guarantees (URDG458)*, ICC Publ'n No. 458 (1992) [hereinafter URDG458]. The URDG has recently undergone a dramatic revision, effective earlier this year. See *Uniform Rules for Demand Guarantees (URDG758)*, ICC Publ'n No. 758 (2010) [hereinafter URDG758].

<sup>4</sup> *The International Standby Practices 1998 (ISP98)*, ICC Publ'n No. 590 (Jan. 1, 1999) [hereinafter ISP98].

<sup>5</sup> United Nations Convention on Independent Guarantees and Stand-by Letters of Credit art. 5, Dec. 11, 1995, A/RES/50/48, available at <http://www.uncitral.org/pdf/english/texts/payments/guarantees/guarantees.pdf> [hereinafter The Convention]. As of 1 November 2010, eight nations have ratified or acceded to the Convention: Belarus, Ecuador, El Salvador, Gabon, Kuwait, Liberia, Panama and Tunisia. The United States of America has signed the Convention but has not yet ratified it or acceded to it. United Nations Treaty Status Database ch. X § 15, <http://treaties.un.org/doc/Publication/MTDSG/Volume%20I/Chapter%20X/X-15.en.pdf> (last visited Nov. 1, 2010).

<sup>6</sup> The Convention, *supra* note 5, art. 1(1)(a) (stating that the Convention applies "if the place of business of the guarantor/issuer at which the undertaking is issued is a Contracting State."). See also *id.* art. 28(2).

<sup>7</sup> *The Uniform Customs and Practice for Documentary Credits (UCP600)*, ICC Publ'n No. 600 (July 1, 2007) [hereinafter UCP600].

<sup>8</sup> *The Uniform Customs and Practice for Documentary Credits (UCP500)*, ICC Publ'n No. 500 (January 1, 1994) [hereinafter UCP500].



Convention have both attempted to protect the principal of a demand guarantee against unfair calls in a manner that severely weakens the principle of autonomy, whereas the URDG have attempted to effect a compromise between the parties by effectively subjecting all calls on demand guarantees to documentary conditions.<sup>9</sup>

### **Uniform Customs and Practice for Documentary Credits**

UCP600 contains no provisions that attempt to prevent unfair or fraudulent calls on commercial or standby letters of credit.<sup>10</sup> Neither did its predecessor, UCP500. The UCP do not deal with the problems that arise where documents presented under a credit are forged or otherwise fraudulent.<sup>11</sup> Article 34 of UCP600 goes as far as stating that a “bank assumes no liability or responsibility for the form, sufficiency, accuracy, genuineness, falsification or legal effect of any document.”<sup>12</sup> In fact, the UCP are completely silent on the issue of fraud and the fraud exception (i.e., fraud rule). The reason for this is that the UCP were primarily devised to provide a contractual framework for dealings between issuers and

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<sup>9</sup> See Charles Debattista, *Performance Bonds and Letters of Credit: A Cracked Mirror Image*, J. BUS. L. 289, 295 (1997).

<sup>10</sup> The UCP applies to commercial letters of credit. In the 1980s, the ICC promulgated the first version of the UCP (UCP400) to provide that the UCP would also apply to standby letters of credit, to the extent to which they may be applicable to standby letters of credit. *The Uniform Customs and Practice for Documentary Credits (UCP400)*, ICC Publ'n No. 400 art. 1 (1983) [hereinafter UCP400]. In 1993, the ICC revised the 1983 version and promulgated the 1993 version (UCP500) with a similar scope provision. UCP500, *supra* note 8, art. 1. See also John F. Dolan, *The UN Convention on International Independent Undertakings: Do States with Mature Letter-of-Credit Regimes Need It?*, 13 BANKING & FIN. L. REV. 1, 2 (1998). The 1993 version was similarly revised and promulgated in 2006 (UCP600). See UCP600, *supra* note 7. Although the UCP apply to commercial letters of credit and standby letters of credit, by implication they also apply to demand guarantees, since demand guarantees, though not mentioned in the UCP, are the same from a legal viewpoint as standby letters of credit. See Roy Goode, *Abstract Payment Undertakings and the Rules of the International Chamber of Commerce*, 39 ST. LOUIS U. L.J. 725, 729 n.20 (1995) [hereinafter Goode, *Abstract Payment*]; and ROY GOODE, ICC PUBL'N NO. 510, *GUIDE TO THE ICC UNIFORM RULES FOR DEMAND GUARANTEES 8* (1992) [hereinafter the *GUIDE TO THE URDG*].

<sup>11</sup> Buckley, *supra* note 1, at 312-13.

<sup>12</sup> UCP600, *supra* note 7, art. 34. The UCP500 contained a similar provision. See UCP500, *supra* note 8, art. 15.

beneficiaries, and issuers and correspondent banks.<sup>13</sup> The UCP do not deal with the rights and duties of parties to the underlying contract, nor is it the function of the UCP to regulate issues that are the proper province of national law and national courts.<sup>14</sup> The content and the interpretation of the ICC uniform rules are equally influenced by the fact that their function is to serve as rules of best banking practice, not rules of law; and the issue of the fraud exception is commonly considered as the responsibility of the applicable national law and of the courts of the forum.<sup>15</sup> Therefore, national laws should deal with any injunctive relief on the grounds of fraud by the beneficiary. The drafters of the UCP500 and UCP600 deliberately decided to leave out the fraud issue.<sup>16</sup> Accordingly, the lack of a provision for fraud in the UCP demonstrates the intention of the drafters that the issue of fraud should be determined by the applicable national law.<sup>17</sup> As Ross Buckley suggests, “The difficulty with leaving these issues to national law is that, except in the United States, such cases come so rarely before the courts that there are very limited opportunities to develop a coherent body of rules.”<sup>18</sup>

The view has been expressed that the decision of the drafters of the UCP500 not to address the issue of fraud “reflected either an unwillingness to tackle a difficult but necessary issue or an outdated view of the limited scope of the UCP as merely a codification of bankers’ practices rather than a dispositive regime of rules.”<sup>19</sup> It has been said that one of the main weaknesses of the UCP500 was that it did not address the rights of an

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<sup>13</sup> Xiang Gao, *The Fraud Rule in the Law of Letters of Credit: A Comparative Study* 56 (Kluwer Law Int’l 2002).

<sup>14</sup> *Id.*

<sup>15</sup> Goode, *Abstract Payment*, *supra* note 12, at 727.

<sup>16</sup> GAO, *supra* note 13.

<sup>17</sup> For instance, in England, South Africa and Australia, the common law applies, but in the United States Revised Article 5, Section 5-109 of the Uniform Commercial Code (hereinafter the ‘UCC’) applies. *See also* John F. Dolan, *Commentary on Legislative Developments in Letter of Credit Law: An Interim Report*, 8 BANKING & FIN. L. REV. 53, 63 (1992); Katherine A. Barski, *Letters of Credit: A Comparison of Article 5 of the Uniform Commercial Code and the Uniform Customs and Practice for Documentary Credits*, 41 LOY. L. REV. 735, 751 (1996); GAO, *supra* note 15, at 56.

<sup>18</sup> Ross P. Buckley, *The 1993 Revision of the Uniform Customs and Practice for Documentary Credits*, 28 GEO. WASH. J. INT’L L. & ECON. 265, 303 (1995).

<sup>19</sup> *Id.* at 302.

applicant of a documentary credit against a bank that proposes to pay on documents that are forged or otherwise fraudulent.<sup>20</sup>

Then again, several commentators have welcomed this inactive approach of the UCP as a remarkable success. It is their view that any attempt by the ICC to formulate a uniform fraud exception is unnecessary and bound to fail, since the fraud exception is rather sensitive to national laws and these rules vary among jurisdictions.<sup>21</sup> They contend that the current position of the UCP may generate an incentive for the different jurisdictions to fashion fraud exceptions that do not interfere with the marketability of credits issued by the jurisdiction's banks.<sup>22</sup>

Xiang Gao disagrees.<sup>23</sup> He is of the view that although it is correct that the UCP are technically not law, but a collection of accepted commercial practices, the truth is that the UCP are currently incorporated into substantially all cross-border commercial letters of credit (and also to a lesser extent into standby letters of credit), studied and observed by letter of credit bankers and users globally, and accordingly, treated as *quasi-law* of credit. Therefore, the UCP have basically become *de facto* law. He also says that a good commercial law is one that serves commerce best. A law that serves commerce best maximises certainty and predictability for the commercial world. To have such an effect, a law should provide the best answer it can give to problems that can be predicted. Furthermore, it is debatable whether the UCP satisfy this standard without dealing with the fraud issue. Although the drafters of the UCP knew of this problem and that it caused problems in documentary credit transactions, they still chose not to address it, leaving users of commercial and standby letters of credit without any guidance on how to deal with the fraud they might encounter.<sup>24</sup> Accordingly, this has left both the commercial and standby letter of credit community with a degree of uncertainty and unpredictability.<sup>25</sup>

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<sup>20</sup> *Id.* at 312–313.

<sup>21</sup> Janet Ulph, *The UCP600: Documentary Credits in the Twenty-first Century*, J. BUS. L. 355, 371 (2007).

<sup>22</sup> *See* Dolan, *supra* note 17, at 63; Barski, *supra* note 17, at 751; GAO, *supra* note 13, at 56.

<sup>23</sup> *See* GAO, *supra* note 13, at 56–57.

<sup>24</sup> *Id.*

<sup>25</sup> *Id.*

In Gao's view, what makes matters worse is the fact that national fraud exceptions are often diverse and lacking in clarity.<sup>26</sup> In such a situation, when a fraud case goes to court and a decision is made, the decision will most likely not be criticised by the letter of credit experts for not conforming with the practice of the letter of credit community and for being detrimental to the commercial utility of letters of credit. It is therefore ironic that in drafting the UCP, those same letter of credit specialists say that it is for the courts to make the relevant rules. According to Xiang Gao, this is neither logical nor fair to the courts.<sup>27</sup>

It is true that the letter of credit is a specialised commercial creature and that the law governing it is complex. Even letter of credit specialists are at times perplexed by its complicated structure and the relationships between the parties. Although judges should be legal experts, it is not practical to expect each judge to be an expert in the law of letters of credit or to make good law within the short period of time that a case is before a court.<sup>28</sup> In reality, most trial judges have hardly had any experience with letter of credit matters.<sup>29</sup>

I agree with Xiang Gao's opinion that it is desirable for the drafters of the UCP, who are well-known letter of credit experts, to provide guidance for issues commonly raised during practice, such as the issue of fraud. I also concur with his view that even if a detailed rule is not practical, guidance is better than nothing.<sup>30</sup> Schmitthoff had already submitted in 1982 that it would have been desirable for the 1983 version of the UCP<sup>31</sup> to have dealt with the problem of fraud.<sup>32</sup> It is regrettable that the 2007 version of the UCP has again remained silent on the issue of fraud.

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<sup>26</sup> *Id.*

<sup>27</sup> *Id.*

<sup>28</sup> *Id.*

<sup>29</sup> *Id.* See also The Report of the Task Force on the Study of the United States' Uniform Commercial Code Article 5 'An Examination of UCC Article 5 (Letters of Credit)', 45 BUS. LAW. 152, 161 (1990).

<sup>30</sup> See GAO, *supra* note 13, at 57.

<sup>31</sup> UCP400, *supra* note 10.

<sup>32</sup> See Clive M. Schmitthoff, *Export Trade*, 44 J. BUS. L. 319, 321 (1982).

### Uniform Rules for Contract Guarantees

The URCG are aimed at encouraging more equitable practices in the area of contract guarantees<sup>33</sup> particularly by limiting the problem of unfair calling of these guarantees. Therefore, unlike the UCP, the URCG have attempted to deal with the unfair calling of demand guarantees.<sup>34</sup> Of the rules of practice examined in this article the URCG went furthest in protecting the principal against unfair calls.<sup>35</sup> It was considered desirable that the URCG should not provide for first demand guarantees payable without any evidence of default. To prevent abuse by unscrupulous beneficiaries, the URCG therefore provide that “evidence” of default by the principal is required to justify the honouring of a claim under a contract guarantee.<sup>36</sup> It can be expected that in most cases the parties to such a guarantee will specify in it what form of evidence is required. Guarantors have been advised to require documentation prepared independently of the beneficiary and in a form capable of verification by the guarantor.<sup>37</sup> For example, a claim under a performance guarantee could be required to be supported by a certificate from specific engineers indicating the defect in the construction or performance of a particular structure.<sup>38</sup>

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<sup>33</sup> The term “contract guarantees” as used in the URCG refers to three types of contract guarantee: First, *tender guarantees*, whereby a party inviting tenders (the beneficiary) is assured of a specific sum if a party submitting a tender (the principal) fails to sign a contract if his tender is accepted, or fails to meet some other specified obligation arising from the submission of a tender. A second type is the *performance guarantee*, which gives the beneficiary recourse against the guarantor (i.e., payment of a specified amount or, if guarantee so provides, at the guarantor’s option, to arrange for performance of the contract) if the principal fails to perform a relevant contract between him and the beneficiary. The URCG therefore apply to a performance bond as a type of demand guarantee, as well as to a performance guarantee as a type of surety bond. A third type of contract guarantee is the *repayment guarantee*, which assures the beneficiary of the repayment of advances, or payments if the principal fails to fulfill a relevant contract. See Peter J. Parsons, *Commercial Law Note*, in 53 AUSTRALIAN L. J. 224, 225 (R. Baxt ed., 1979). See also URCG, *supra* note 2, art. 2(c)-(e); Lars A.E. Hjerner, *Contract Guarantees*, in INTERNATIONAL CONTRACTS AND PAYMENTS 69, 69-70 (P. Šarčević & P. Volken eds., Graham & Trotman Ltd. 1991).

<sup>34</sup> See GAO, *supra* note 13, at 57.

<sup>35</sup> Debattista, *supra* note 9, at 296.

<sup>36</sup> *Id.* (citing GUIDE TO THE URDG, *supra* note 10, at 6). See also 2 Documentary Credit Insight 9, part 1 (1996).

<sup>37</sup> Parsons, *supra* note 33, at 225.

<sup>38</sup> *Id.*

The ICC later created the URDG with the intention of replacing the URCG. However, since the URDG came into effect in 1992, the ICC has not yet withdrawn the URCG and they are therefore still available for incorporation into demand guarantees should parties choose to do so.<sup>39</sup> One of the main reasons why the URCG are not in general use—and the reason why a new set of rules was required in 1992—lies mainly in the two most important articles of the URCG, namely articles 8 and 9.<sup>40</sup>

Article 8 deals with the submission of claims under a contract guarantee and the relevant paragraphs of this article provide as follows:

- (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.

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<sup>39</sup> GUIDE TO THE URDG, *supra* note 10, at 7.

<sup>40</sup> See Debattista, *supra* note 9, at 296.

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.<sup>41</sup>

As required by paragraph (1) of Article 8, the claim should be made in writing and received by the guarantor no later than the day of expiry. Once the guarantor receives a claim, he should notify the principal or the instructing party, as the case may be, not only of the claim itself, but also of any documentation received. However, problems may arise in relation to the requirement that documentation—preferably a court decision, arbitral award or approval of the principal—be presented by the beneficiary if he makes a claim. Since it may be difficult for the beneficiary to provide adequate documentation at the time of the claim or even before the expiry date of the guarantee, Article 8(3)(c) provides that such documentation may be presented after receipt of the claim within the time limit specified in the guarantee, or failing such specification, as soon as is practical. If a court decision or an arbitral award is required, this can clearly take a long time. However, if the claim has been made, this apparently excludes the guarantee from expiring before the required documentation can be presented. In cases where the beneficiary must provide the necessary documentation himself, for instance, an expert affidavit, a fixed time limit of six months is stipulated.<sup>42</sup>

It has been indicated that the wording of Article 8(3) is ambiguous in that it provides that 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.” It has been suggested that this implies that a claim would not be honoured if the necessary documentation, for example, a court decision or an arbitral award, cannot be presented before the expiry date of the guarantee. Moreover, it appears that the URCG intended to make a distinction between *the last day for a claim* and *the date on which the guarantee ceases to be valid* but failed to do so. In practice, if the claim is made in time, the guarantee does not cease to be valid because the case has not been settled before the expiry date.<sup>43</sup>

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<sup>41</sup> URCG, *supra* note 2, art. 8.

<sup>42</sup> See Parsons, *supra* note 33. See also URCG, *supra* note 2, art. 2(c)-(e). See also Hjermer, *supra* note 33, at 75-76.

<sup>43</sup> See Hjermer, *supra* note 33, at 76.

The most disputed article of the URCG is Article 9, which is concerned with the documentation required to support a claim. In the absence of an express stipulation in the guarantee stipulating the subject of the specific documentation required, Article 9 of the URCG provides as follows:

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 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.<sup>44</sup>

Referring to party autonomy, the first part of Article 9 leaves it to the parties to decide which type of documentation will be required. If the parties fail to include such a specification, the beneficiary is required to submit the documents stipulated in subparagraphs (a) and (b) of Article 9. In a rather confusing way, Article 9 also refers to "on-demand guarantees" (those requiring "only a statement of claim by the beneficiary"). It follows that, if the URCG applies to an on-demand guarantee, in order to be effectively "on-demand" the guarantee must clearly exclude Article 9 or provide that the requirements for documentation under subparagraph (a) and

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<sup>44</sup> URCG, *supra* note 2, art. 9.



(b) do not apply. It will not suffice to state that, although subject to the URCG, the guarantee is payable on first and simple demand.<sup>45</sup> By including on-demand guarantees in this article, the drafters of the URCG deliberately attempted to discourage their use. In this regard, it has been said that they may have gone too far.<sup>46</sup>

The effect of URCG Articles 8(3)(b) and 9 was to make all demand guarantees conditional and, furthermore, to make the conditions to which calls were subject particularly onerous on the beneficiary.<sup>47</sup> If payment under the demand guarantee was subject to justification under the underlying contract or the agreement of the principal, then the guarantee was not truly independent of the underlying contract: for payment to be justified, the veil of the guarantee had to be lifted and justification found in the underlying contract.<sup>48</sup>

In relation to tender guarantees, no court decision or arbitral award is necessary in support of a claim. This is not surprising, since at that stage no contract would have been concluded between the principal and the beneficiary.<sup>49</sup> Therefore, a *bona fide* statement by the beneficiary is adequate in which he acknowledges that the principal's tender was accepted, but thereafter the principal neglected to sign the contract or to provide the performance guarantee as indicated in the tender.<sup>50</sup> In addition to such statement, the beneficiary must offer to have any dispute arising between himself and the principal in connection with the repayment of the amount paid under the tender guarantee settled by arbitration.<sup>51</sup>

Proceeding to performance and repayment guarantees, subparagraph (b) of Article 9 stipulates that a claim must be supported by a court decision or an arbitral award justifying the claim, or the approval of the principal in

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<sup>45</sup> See Hjerner, *supra* note 33, at 76.

<sup>46</sup> *See id.*

<sup>47</sup> Debattista, *supra* note 9, at 296.

<sup>48</sup> *See id.*

<sup>49</sup> Hjerner, *supra* note 33, at 76.

<sup>50</sup> *Id.* at 76-77.

<sup>51</sup> *See id.*

writing to the claim and the sum to be paid.<sup>52</sup> Even though this rule is less complicated than the one in subparagraph (a), it may nevertheless lead to complications. There is no suggestion as to whether the court decision should be final (i.e., no longer subject to appeal). Furthermore, even to obtain a decision in the first place may take considerable time. In the interim, the guarantee is of no use to the beneficiary, although he had probably thought that by using a demand guarantee he would quickly receive the money as compensation for the loss he had incurred due to the alleged breach of the underlying contract with the principal.<sup>53</sup> The situation may even be worse for the beneficiary if disputes between him and the principal have to be settled by arbitration. This is so, because it is well known that even “speedy” arbitration procedures last longer than one year; often two or more years. Such a solution is evidently unsatisfactory if the purpose of the guarantee was to make the money available to the beneficiary simply and speedily. However, it has been said that it has to be balanced against the risk that money had been paid and that in the end the claim could not be justified.<sup>54</sup>

The question has been raised whether Article 9(b) was too severe, and it was even said that it was not clear what the URCG would achieve in this situation.<sup>55</sup> If the beneficiary had to justify his claim by arbitration or litigation, it would cause a delay in him receiving payment in terms of the guarantee. He would also have to incur unnecessary expenses in justifying his claim. However, if the beneficiary met the requirements of Article 9(b), he would be armed with documentation of its own force and effect requiring the honouring of the relevant guarantee.<sup>56</sup>

Goode states that the URCG sought to deal with the problem of unfair calling of demand guarantees (performance guarantees/repayment guarantees) by requiring, as a condition of the beneficiary’s right to payment, the production of a judgment or arbitral award or the principal’s written approval of the claim and the amount.<sup>57</sup> Although the object of this

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<sup>52</sup> *Id.* at 76.

<sup>53</sup> *Id.*

<sup>54</sup> *See id.*

<sup>55</sup> Parsons, *supra* note 33, at 226.

<sup>56</sup> *See id.*

<sup>57</sup> GUIDE TO THE URDG, *supra* note 10, at 6.

requirement was laudable, it did have the effect of limiting the acceptability of the URCG, for it resulted in the exclusion from their scope the simple on-demand guarantee that accounted for the great majority of documentary guarantees issued by banks.<sup>58</sup> Furthermore, although the requirement to produce a judgment or arbitral award was theoretically a documentary requirement, practically it meant that beneficiaries had to prove default by the principal by way of litigation or arbitration, and this tended to defeat the objective of the demand guarantee in providing the beneficiary with a speedy monetary remedy. This requirement was unacceptable to importers (buyers) and because of their strong negotiating position it resulted in the URCG seldom being incorporated.<sup>59</sup> This requirement also did not gain general acceptance because it proved to be too far removed from current banking and commercial practice.<sup>60</sup>

The URCG, since their incorporation in 1978, have been used by parties with varying success. The major criticism voiced has been in relation to Article 9 and the fact that the URCG cannot be easily applied to on-demand guarantees. On-demand guarantees are probably the most common form of guarantees requested by certain groups of beneficiaries. However, by requiring documentation to support the claim, Article 9 directly contradicts the very character of on-demand guarantees, which are intended to assure the availability of the money on demand.<sup>61</sup> It appears that the most severe criticism comes from the continental banking sectors. Conversely, other business sectors have confirmed that the URCG have been accepted in guarantees even with developing countries where government agencies often require submission to local rules and the use of on-demand guarantees. Even with their limited success, it appears that discontent still exists.<sup>62</sup>

Although the purpose of the above-mentioned provisions of the URCG is to prevent fraud, they are strictly speaking not the same as the

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<sup>58</sup> *Id.*

<sup>59</sup> *Id.*

<sup>60</sup> See Roeland Bertrams, *Bank Guarantees in International Trade: The Law and Practice of Independent (First Demand) Guarantees and Standby Letters of Credit in Civil Law and Common Law Jurisdictions* 28 (3d. ed., Kluwer Law Int'l 2004).

<sup>61</sup> Hjerner, *supra* note 33, at 78.

<sup>62</sup> See *id.* at 77-78.

traditional fraud exception as found in the English, American and South African jurisdictions.<sup>63</sup> In these jurisdictions the fraud exception is concerned with the circumstances under which payment under a demand guarantee may be disrupted, whereas Article 9 provides the conditions that trigger the payment of demand guarantees.<sup>64</sup>

### Uniform Rules for Demand Guarantees

Owing to the problems experienced as a result of using the URCG, the drafters of URDG458<sup>65</sup> decided to adopt an approach similar to the one taken in the UCP on the issue of fraud in relation to demand guarantees, by simply remaining silent and leaving it to the courts of the various jurisdictions to deal with.<sup>66</sup>

During the formulation of URDG458, conflicting views reflecting the competing interests of the parties involved were expressed. At one end of the spectrum banks required a simple instrument whereby the issuer (guarantor) would have to pay without having to make difficult investigations or take complicated decisions based on doubtful evidence.<sup>67</sup>

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<sup>63</sup> For a full discussion of how the fraud exception is dealt with in England and the United States, see GAO, *supra* note 13; MICHELLE KELLY-LOUW, SELECTIVE LEGAL ASPECTS OF BANK DEMAND GUARANTEES: THE MAIN EXCEPTIONS TO THE AUTONOMY PRINCIPLE (Published LLD thesis, University of South Africa) 213-322 (VDM Verlag Dr. Müller Aktiengesellschaft & Co. KG 2009) and for a discussion of how the exception is dealt with in South Africa, see Kelly-Louw, *supra*, at 323-339.

<sup>64</sup> See GAO, *supra* note 13, at 58.

<sup>65</sup> The URDG are intended to apply worldwide to the use of demand guarantees, specifically guarantees, bonds or other payment undertakings, however named or described, under which the duty of the guarantor/issuer (i.e., a bank, insurance company or other body or person) to make payment arises on the presentation of a written demand and any other documents specified in the guarantee (e.g., a certificate by an engineer) and is not conditional on actual default by the principal in the underlying transaction. See URDG458, *supra* note 3, art. 2(a). Standby letters of credit unquestionably fall within the definition of "demand guarantee" as set out in article 2(a) of the URDG. Therefore, although the URDG apply to demand guarantees rather than to standby letters of credit, standby letters of credit may also be governed by the URDG if the parties elect to incorporate it. However, it was felt that the UCP were a more suitable set of rules for standby letters of credit than the URDG. *Id.* at 4; see also GUIDE TO THE URDG, *supra* note 10, at 7. This was the case, of course, until the ISP98 came into operation in 1999, which specifically deals with standby letters of credit. See *infra* at 94.

<sup>66</sup> See GAO, *supra* note 13, at 58.

<sup>67</sup> *Id.*

At another end, beneficiaries were claiming that they needed a device that would enable them to get paid against a simple demand or document without risking obscure objections. Then at a totally different end, principals were interested in having some kind of safety mechanism in the system so as to prevent unfair callings.<sup>68</sup>

Therefore, URDG458 attempts to affect a compromise between the interests of the beneficiaries to obtain speedy payment and that of the principals to avoid the risk of unfair calling by the beneficiaries.<sup>69</sup> From all this, in order to prevent the beneficiary's outright unfair calling, a few fundamental articles, in particular Articles 9, 17, 20 and 21, were incorporated into URDG458. However, as will be seen below, Article 20 implicitly goes a small way towards restricting the beneficiary's right of payment.<sup>70</sup>

Article 20(a) and (c) provides as follows:

- (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 . . .
- (c) Paragraph (a) of this Article applies except to the extent that it is expressly excluded by the terms of the Guarantee . . .<sup>71</sup>

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<sup>68</sup> *Id.*

<sup>69</sup> *See* Debattista, *supra* note 9, at 297.

<sup>70</sup> *See* GAO, *supra* note 13, at 58-59.

<sup>71</sup> URDG458, *supra* note 3, art. 20(a), (c).

Furthermore, Article 9 provides that

[a]ll 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.<sup>72</sup>

Interests of the beneficiary and the principal are built upon a compromise that has three characteristics.<sup>73</sup> First, although URDG458 clearly states in Article 2(b) that the demand guarantee is independent, they still seek to justify the call in terms of the underlying contract. Second, that connection is weakened in the sense that the requirement in the URDG of a court decision or arbitral award, or the agreement of the principal, is substituted by a detailed allegation—itsself contained in a document and at times accompanied by other specific documents—by the beneficiary of a breach by the principal. Third, the allegation and any accompanying documents are subjected to the scrutiny of strict compliance by the paying bank (guarantor), very much as if a call on a demand guarantee were the same as a demand for payment under a letter of credit. Therefore, URDG458 has retained the principle of autonomy, but has counter-balanced it by the doctrine of strict compliance.<sup>74</sup>

Article 20 of URDG458 contains a very distinctive rule requiring the beneficiary to present with his demand a statement that the principal is in breach and the respect in which he is in breach.<sup>75</sup> The expression “the respect in which” as apposed to “respects” is intended to require only a general statement of the nature of the breach, for example, that the principal has been guilty of delay or defective workmanship, not a detailed specification.<sup>76</sup> Therefore, Article 20 requires the beneficiary, when demanding payment, to stipulate in writing both that there is some kind of breach of the underlying contract and what type of breach is involved,

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<sup>72</sup> *Id.* art. 9.

<sup>73</sup> Debattista, *supra* note 9, at 297.

<sup>74</sup> *Id.*

<sup>75</sup> GUIDE TO THE URDG, *supra* note 10, at 92.

<sup>76</sup> *See id.* at 93-94; Goode, *Abstract Payment*, *supra* note 10, at 725 n.47.

therefore giving the other party or parties some form of protection by providing a ground for a claim of fraud.<sup>77</sup> This places a certain obligation on the beneficiary to show his hand. The aim of this provision is to give some measure of protection against the unfair calling of the guarantee without interfering with the documentary character of the guarantee and the need of the beneficiary to have speedy recourse in the event of a perceived breach. It has been said that although the protection is rather limited in that it is the beneficiary himself, rather than an independent third party, who has to issue the statement of breach, the effect of this should not be too lightly dismissed.<sup>78</sup> Beneficiaries who may be quite ready to make an unjustified demand, if this is all that is required, may be more reluctant to commit themselves to a false statement of breach, particularly where the general nature of this has to be identified. This article does not affect the documentary character of the demand guarantee. The guarantor is not required to investigate the truth of the beneficiary's statement that the principal is in breach.<sup>79</sup> In its nature, Article 20 of URDG458 is similar to that of Article 9 of the URCG, in that it provides a kind of safety device against the triggering of the payment of the demand guarantee to prevent fraud. Article 20 (just as Article 9 of the URCG does) differs from the traditional fraud exception as found in the English, American and South African jurisdictions. The traditional fraud exception found in these jurisdictions, unlike Article 20 of the URDG458, specifically addresses what to do when fraud is found to have been committed.<sup>80</sup>

Although the word "fraud" is not used in the URDG, the prevention of fraud is central to URDG458. The demand for payment must stipulate the reasons for calling on the guarantee in order to meet the URDG458's clear preference for reasoned demand guarantees. It is hoped that the requirement of providing reasons will prevent fraud. However, commentators have doubted the effectiveness of reasoned demand guarantees. It has been said

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<sup>77</sup> There is a similar provision relating to counter-guarantees. In terms of Article 20(b), any demand under the counter-guarantee is to 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 Article 20 itself. In other words, the guarantor, when claiming under the counter-guarantee, is required to certify that the beneficiary's demand was accompanied by the statement of breach required by Article 20. *See Goode, Abstract Payment*, *supra* note 10, at 739-740.

<sup>78</sup> *See GUIDE TO THE URDG*, *supra* note 10, at 92-93.

<sup>79</sup> *See Goode, Abstract Payment*, *supra* note 10, at 739-740.

<sup>80</sup> *See GAO*, *supra* note 13, *supra* note 13, at 59.

that in order to prevent fraud, it is imperative that the principal is informed about the demand for payment.<sup>81</sup> Article 17 of URDG458 obliges banks to do so, but does not require a bank to hold payment until the principal has been made aware of the demand and its reasons. Therefore, banks may use their discretion to decide whether or not to wait with payment, or to proceed with payment as long as the principal is informed. In the event of fraud, the principal will then have the opportunity of requesting provisional and/or conservatory measures from a competent court.<sup>82</sup> However, as no requirement for withholding payment is imposed, the fraud prevention provided in Article 17 is without much force if a bank decides to pay before the principal has been able to obtain interim relief. URDG458's purpose, however incomplete, is to achieve a more even distribution of risk between principal parties and beneficiary parties than was previously the case. It would appear that from the side of principals, the rules have been welcomed. However, it seems that beneficiaries will not frequently accept URDG458, since these rules worsen their position.<sup>83</sup>

Furthermore, the ICC has incorporated Article 21 into the URDG in an attempt to prevent unfair calls.<sup>84</sup> Article 21 provides that "[t]he 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."<sup>85</sup>

The purpose of Article 21 is to give the principal the chance to challenge an unfair call before payment is made under it.<sup>86</sup> Article 21 obliges the bank to send the beneficiary's demand and any prescribed documents to the principal, but it does not require a bank to hold payment until the principal has received the demand and the documents. Therefore, as with Article 17 (discussed above), guarantors (banks) may again use their discretion to decide whether or not to wait with payment, or to proceed with

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<sup>81</sup> See Filip De Ly, *The UN Convention on Independent Guarantees and Stand-by Letters of Credit*, 33 INT'L LAW. 831, 835 (1999).

<sup>82</sup> *Id.*

<sup>83</sup> *See id.* at 835–836.

<sup>84</sup> GUIDE TO THE URDG, *supra* note 10, at 92.

<sup>85</sup> URDG458, *supra* note 3, art. 21.

<sup>86</sup> *See* GUIDE TO THE URDG, *supra* note 10, at 92.



payment as long as the demand and relevant documents have been transmitted to the principal.<sup>87</sup> Article 21 also does not contain a provision that payment will be withheld until the principal has obtained interim court relief. Therefore, the fraud prevention provided in Article 21 is also without much force if a bank decides to pay before the principal has been able to obtain interim relief.<sup>88</sup>

It was intended that URDG458 would replace the URCG, which had proved a failure in consequence of the complex payment procedure that they introduced. In contrast, URDG458 provides a simple mechanism, based on the guarantor's unconditional duty to meet a demand or call on the facility as set out in Article 20.<sup>89</sup> However, in spite of this, URDG458 initially did not gain wide acceptance and was, until recently,<sup>90</sup> rarely

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<sup>87</sup> *Id.* at 101.

<sup>88</sup> *See* De Ly, *supra* note 81, at 835-836.

<sup>89</sup> *See* E. P. Ellinger, *British Business Law: Banking Law*, J. BUS. L. 704, 704 (2005).

<sup>90</sup> During the first couple of years of their existence, it seemed that the URDG were not widely accepted. At the end of 2005, the URDG still had not gained wide acceptance and were not frequently used in practice. The exact reason for this limited acceptance is not clear. *See* Paul S. Turner, *New Rules for Standby Letters of Credit: The International Standby Practices*, 14 BANKING & FIN. L. REV. 457, 485 n. 3 (1999). For a discussion of possible reasons, *see* Ellinger, *supra* note 89, at 705. During recent years, however, it seems that the URDG have grown in popularity and are currently being used by banks worldwide. For example, Chinese Banks generally issue their demand guarantees subject to the URDG. *See* D. A. Laprès & J. Mo, *L/Cs, Collections, Guarantees and Other Instruments in the PRC*, 13 DCINSIGHT 21 (Oct.-Dec. 2007), and in 2004, the Central Bank of Iran (Bank Markazi Jomhuri Islami Iran) issued a circular indicating that Iranian banks could use the URDG. DCI Interview with Farideh Tazhibi, *The URDG and Demand Guarantees in Iran*, 14 DCINSIGHT 11 (Jan.-Mar. 2008) [hereinafter 'Tazhibi Interview']. *See also*, DCI Interview with Andrea Hauptmann, *Insights on the URDG Revision*, 13 DCINSIGHT 5, 5 (Oct.-Dec. 2007) [hereinafter 'Hauptmann Interview']. However, in a fairly recent survey conducted by SITPRO (formerly, the Simpler Trade Procedure Board: a non-departmental public body for which the United Kingdom's Department of Trade and Industry has responsibility) it was shown that in the United Kingdom the URDG were not often used and the respondents (i.e., exporters and banks) to the survey indicated that they preferred to issue demand guarantees subject to UCP500. Banks that took part in the survey indicated that the URDG did not reflect United Kingdom or international banking practices. SITPRO, *Report on the Use of Demand Guarantees in the UK* 8, 10 (July 2003), <http://www.sitpro.org.uk>. The URDG were adopted in 1999 by the International Federation of Consulting Engineers in their model guarantee forms and later in 2002 also by the World Bank. *See* DCI Interview with Georges Affaki, *On Revising the Uniform Rules for Demand Guarantees (URDG)*, 13 DCINSIGHT 18, 18 (Jan.-Mar. 2007). A few national lawmakers have even taken the URDG as a model for independent guarantee statutes. *See, e.g.*, the Uniform Act Organizing Securities (adopted on 17 April 1997 and enforced by

incorporated in first-demand guarantees or in performance guarantees.<sup>91</sup> One of the reasons for this limited acceptance was apparently due to certain banks' objection that Article 20(a), which provides that the payment condition is a written demand for payment supported by a specific statement of default, is contrary to the on-demand guarantees (i.e., guarantees payable on simple or first demand) which do not require such a statement.<sup>92</sup> Banks objected to this payment condition, despite the fact that Article 20(c) allows parties to exclude the requirement of a statement of default.

The Drafting Group appointed to revise and redraft URDG458<sup>93</sup> indicated that special attention was given to Article 20 during the drafting process. At this point, it seems that the crux of the contentious Article 20 will be kept, but that some of the misunderstanding surrounding it will be clarified in the revised version.<sup>94</sup> Whether better success will be achieved by taking a new approach in a revised article remains to be seen.

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derogation on 1 January 1998) as adopted by the 16 African states belonging to OHADA (i.e., the French acronym for the Organization for the Harmonization of Business Law in Africa and includes the following states: Benin, Burkina Faso, Cameroon, Central African Republic, Comoros, Congo, Côte d'Ivoire, Gabon, Guinea, Guinea Bissau, Equatorial Guinea, Mali, Niger, Senegal, Tchad and Togo) provides that the demand for payment under a demand guarantee must not only state that the principal has defaulted, but also in what respect the principal has defaulted on his contractual obligations towards the beneficiary, a provision based on Article 20 of the URDG. Pradeep Taneja, *The URDG Revision and Islamic Banking*, 14 DCINSIGHT 14, 14 (Apr.-June 2008). Seminars worldwide on the rules have also started to attract enthusiastic audiences. See *ICC to Revise its Uniform Rules for Demand Guarantees*, <http://www.iccwbo.org/iccbdfie/index.html> (last accessed Nov. 16, 2009). It has taken more than a decade for the URDG to achieve its objective of being accepted internationally, but it is not nearly as widely used as the UCP. The impact of the recent revision (URDG758, *supra* note 3) on international acceptance remains to be seen.

<sup>91</sup> Ellinger, *supra* note 89, at 704-705.

<sup>92</sup> See *id.* at 704.

<sup>93</sup> The revision to the URDG has just completed and is embodied within URDG758, *supra* note 3. The process began in 2007, when the ICC Banking Commission gave the go-ahead to begin a revision of the URDG. The revision was entrusted to a Drafting Group consisting of guarantee experts from a wide range of countries. See *ICC to Revise its Uniform Rules for Demand Guarantees*, *supra* note 91. For a brief discussion on which issues were looked at during the drafting process, see the Hauptmann Interview, *supra* note 91, at 5-6; see also Tazhibi Interview, *supra* note 91, at 11-12.

<sup>94</sup> See Hauptmann Interview, *supra* note 93, at 6; Tazhibi Interview, *supra* note 93, at 12.

### International Standby Practices (ISP98)

ISP98 does not attempt to regulate fraud or abusive drawing, taking a similar approach to the UCP.<sup>95</sup> In Rule 1.05(c), ISP98 expressly leave the issue of fraudulent or abusive demands for payment (drawings) or “defenses to honour based on fraud, abuse or similar matters” to be determined by the applicable jurisdictional law, for instance Revised UCC Article 5-109 (in the case of the United States) or Articles 19 and 20 of the Convention (where a state/country has adopted the Convention).<sup>96</sup>

Professor Byrne states that although ISP98 provides no systematic rule with regard to fraud or abuse, it does contain rules based on principles that would provide important guidance in determining whether and what

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<sup>95</sup> See ISP98, *supra* note 4. The Institute of International Banking Law and Practice created ISP98 with the support of the United States Council on International Banking, Incorporated (“USCIB,” is now known as the International Financial Services Association or “IFSA”). The IFSA adopted ISP98, after which it was also submitted to the ICC for approval. During 1998, the ICC Banking Commission endorsed the rules, where after they came into operation on January 1, 1999. ISP98 is intended to apply to domestic and international standby letters of credit, providing separate rules for standby letters of credit in the same sense that the UCP do for commercial letters of credit and the URDG do for demand guarantees. ISP98, *supra* note 4, at *Preface*. Rule 1.01 outlines the scope and application of the ISP98, and indicates the types of undertaking for which the rules are intended. Though the intended use of the ISP98 is for international and domestic standby letters of credit, it is not limited to standby letters of credit. Theoretically, any international or domestic undertaking, however far removed from a standby letter of credit, can be issued subject to ISP98. ISP98, *supra* note 4, R. 1.01(b). The use of ISP98 for dependent undertakings (such as suretyship guarantees) and *quasi*-independent undertakings (such as commercial paper or negotiable instruments) is not intended or suitable and will lead to confusion. However, it may be used for independent undertakings, such as demand guarantees, although the URDG have been specifically drafted for this type of undertaking. See James E. Byrne, *The Official Commentary on the International Standby Practices*, Rule 1.01 cmt. 2 (James G. Barnes ed., Inst. of Int'l Banking Law & Practice, Inc. 1998) [hereinafter *The Official Commentary on the ISP98*]. By their terms, the rules apply to a letter of credit or independent undertaking that incorporates them by express reference, such as “this letter of credit is subject to ISP98” or “subject to ISP98.” See Turner, *supra* note 90, at 458; Byrne, *The Official Commentary on the ISP98*, *supra*, at R. 1.01 cmt. 10. Therefore, like the UCP and the URDG, ISP98 also applies to any independent undertaking, such as demand guarantee, issued subject to it. ISP98, *supra* note 4, R. 101(b). So therefore, parties themselves are allowed to choose the applicable set of rules. In other words, a party may choose to use ISP98 for certain types of standby letters of credit, the UCP for others and the URDG for still others. See GAO, *supra* note 13, at 20–21; see also ISP98, *supra* note 4, at *Preface*.

<sup>96</sup> See GAO, *supra* note 13, at 59. For a full discussion of Articles 19 and 20 of the Convention, see *infra* at 99.

remedy might be appropriate in the event of fraud.<sup>97</sup> These principles include the documentary character of the undertaking; the absence of any duty to investigate the transaction beyond the face of the complying document; the right to reimbursement for payments made in good faith, notwithstanding the fraudulent or forged character of the documents; the independence of transferee beneficiaries from the consequences of any fraudulent or abusive conduct on the part of the first beneficiary; and the right of nominated persons who have acted within the scope of their nomination to obtain reimbursement, notwithstanding the presence of fraudulent or abusive drawings. ISP98 is also based on the assumption that an exception to the obligation to pay and the independence principle arise only in the case of material fraud or clear, manifest abuse.<sup>98</sup>

The omission of the fraud exception from ISP98 has, nonetheless, been commended by some commentators as an act that is “especially welcome,” because fraud has been addressed in different ways in different countries.<sup>99</sup> It has been said that if provisions on fraud were to be included in ISP98, it would probably have created needless complications in countries such as the United States, where the issue of fraud has been dealt with by the courts and legislators in detail over a long period of time.<sup>100</sup> Dolan states that it was a wise decision of the drafters of ISP98 to leave questions regarding the troublesome subject of fraud in the transaction to local law.<sup>101</sup> He further indicates that a major failing of the Convention lies in UNCITRAL’s attempt to codify rules dealing with that subject. According to him, fraud exceptions are best left to local law, because questions of fraud are inextricably entwined with matters of local procedural law and because the notion of fraud itself varies from jurisdiction to jurisdiction. It is the market that will sort out the problem. Jurisdictions that do not fashion efficient rules, procedurally and otherwise, for resolving questions of fraud, will find credits issued by their banks

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<sup>97</sup> See Byrne, *The Official Commentary on the ISP98*, *supra* note 95, at R. 1.05(c) cmt. 5(c).

<sup>98</sup> *Id.*

<sup>99</sup> Turner, *supra* note 90, at 463.

<sup>100</sup> *Id.*

<sup>101</sup> John F. Dolan, *Analyzing Bank Drafted Standby Letter of Credit Rules, the International Standby Practices (ISP98)*, 14 WAYNE L. REV. 1865, 1901 (2000) [hereinafter Dolan, *Analyzing*]. For criticism of the Convention’s attempt to legislate fraud, see Dolan, *supra* note 10, at 1. For further discussion of this subject, see *infra* at 105.

unacceptable in world markets. Dolan is of the view that ISP98, like the UCP, correctly eschews the question of fraud.<sup>102</sup> However, Xiang Gao rightly disagrees with this, and states that avoiding problems might not be the best way to resolve them.<sup>103</sup>

Although there is no rule dealing with fraudulent or abusive demands, there are a few rules that are relevant for purposes of this article and should therefore be considered in more detail. For instance, ISP98 Rule 4.08 provides that even if a standby letter of credit does not specify any required document, it will still be deemed to require a documentary demand for payment.<sup>104</sup> Therefore, when a standby letter of credit does not call for a demand explicitly, the standby is not properly called on by the beneficiary unless it includes a demand in the package of documents presented to the issuer.<sup>105</sup> The effect of this rule is that if the issuer leaves out the requirement for the demand, the beneficiary who does not present one will have made a non-complying presentation and may lose the entire benefit of the standby.<sup>106</sup>

ISP98 has created certain rules setting out certain data that must be included in a demand made under a standby letter of credit. For instance, Rule 3.03 stipulates that the demand identifies the standby.<sup>107</sup> Such a requirement is important to a bank issuer that may have thousands of outstanding standby credits in favour of the beneficiary that is making the demand. This rule renders any draft or demand that does not identify the credit non-compliant, even when the credit does not contain that requirement, although the issuer may, on its own motion, waive this

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<sup>102</sup> See Dolan, *Analysing*, supra note 101.

<sup>103</sup> See GAO, supra note 13, at 60.

<sup>104</sup> ISP98, supra note 4, R. 4.08 (“If a standby does not specify any required document, it will still be deemed to require a documentary demand for payment.”). For criticism of ISP98 Rule 4.08, see Dolan, *Analysing*, supra note 101, at 1893.

<sup>105</sup> Dolan, *Analysing*, supra note 101, at 1893.

<sup>106</sup> *Id.*

<sup>107</sup> ISP98, supra note 4, R. 3.03 (“A presentation must identify the standby under which the presentation is made.”).

requirement under rule 3.11(a)(ii).<sup>108</sup> Furthermore, ISP98 Rule 14.16, under the heading “Demand for Payment,” provides as follows:

- (a) A demand for payment need not be separate from the beneficiary’s statement or other required document.
- (b) If a separate demand is required, it must contain:
  - i. a demand for payment from the beneficiary directed to the issuer or nominated person;
  - ii. a date indicating when the demand was issued;
  - iii. the amount demanded; and
  - iv. the beneficiary’s signature.
- (c) A demand may be in form of a draft or other instruction, order, or request to pay. If a standby requires presentation of a “draft” or “bill of exchange”, that draft or bill of exchange need not be in negotiable form unless the standby so states.<sup>109</sup>

In addition to this rule, ISP98 also stipulates the content of a certificate of default. Most standby letters of credit call for two documents: (1) a demand or draft and (2) a certificate indicating that the drawing event (e.g., default) has occurred or that payment is due; commonly a certificate of default.<sup>110</sup> In this regard, ISP98 Rule 14.17, under the heading “Statement of Default or Other Drawing Event,” provides as follows:

If a standby requires a statement, certificate, or other recital of a default or other drawing event and does not specify content, the document complies if it contains:

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<sup>108</sup> *Id.* R. 3.11.a.ii (“In addition to other discretionary provisions in a standby or these Rules, an issuer may, in its sole discretion, without notice to or consent of the applicant and without effect on the applicant’s obligations to the issuer, waive (a.) the following Rules and any similar terms stated in the standby which are primarily for the issuer’s benefit or operational convenience ... (ii.) identification of a presentation to the standby under which it is presented ...”).

<sup>109</sup> *Id.* R. 14.16. For a discussion of this rule, see Byrne, *The Official Commentary on the ISP98*, *supra* note 95, at R. 4.16 cmts. 1-7.

<sup>110</sup> Dolan, *Analysing*, *supra* note 101, at 1893.

- (a) a representation to the effect that payment is due because a drawing event described in the standby has occurred;
- (b) a date indicating when it was issued; and
- (c) the beneficiary's signature.<sup>111</sup>

It follows that under Rules 3.03, 4.08, 4.16 and 4.17 of ISP98, a demand for payment under a standby letter of credit is not required to indicate a default or other event in the underlying contract, if that is not required under the terms and conditions of the standby letter of credit. This is a step back from the position of the URDG, where the beneficiary is required to state that there is a breach of the underlying contract and what type of breach is involved.<sup>112</sup>

Furthermore, the issuer under Rule 3.10 of the ISP98, unlike Article 17 of the URDG, is not required to notify the applicant (the principal in the case of a demand guarantee) of receipt of a demand for payment under the standby letter of credit.<sup>113</sup> Article 17 of the URDG requires "in the event of a demand" that the guarantor "shall without delay" notify the principal or his instructing party.<sup>114</sup> Rule 3.10 is consistent with the standby letter of credit practice that rejects the notion embodied in Article 17 that the issuer has a duty to notify the applicant upon receipt of a demand under a standby.<sup>115</sup>

Byrne has explained the rationale behind Rule 3.10.<sup>116</sup> Apparently, the concern raised is that by giving notice to the applicant before payment is

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<sup>111</sup> ISP98, *supra* note 4, R. 14.17. For a discussion of this rule, see Byrne, *The Official Commentary on the ISP98*, *supra* note 95, at R. 4.17 cmts. 1-3; *but cf.* Dolan, *Analysing*, *supra* note 101, at 1894.

<sup>112</sup> For a discussion of Article 20(a) of the URDG, see *supra* 88; GAO, *supra* note 13, at 60.

<sup>113</sup> ISP98, *supra* note 4, R. 3.10 ("An issuer is not required to notify the applicant of receipt of a presentation under the standby."). See De Ly, *supra* note 81, at 836.

<sup>114</sup> See URDG458, *supra* note 3, art. 17.

<sup>115</sup> De Ly, *supra* note 81, at 837.

<sup>116</sup> Byrne, *The Official Commentary on the ISP98*, *supra* note 95, at R. 3.10.

made might have the effect that the applicant might seek to prevent payment by trying to obtain a judicial order restraining payment.<sup>117</sup> While it is agreed that such relief may be appropriate in the case of an abusive or fraudulent drawing, it is not appropriate in the event of a contractual dispute between the applicant and beneficiary. It is stated that, in fact, many standbys are meant to be drawn upon in just such a situation. It has been said that to propose a duty to give notice calls into question the neutrality of the issuer; a concept that is at the heart of the standby's commercial value.<sup>118</sup> It is agreed that there may, of course, be valid commercial reasons for contacting the applicant prior to honour, for example, in order to notify the applicant that he is being called upon to fund the drawing. The abuse of such notice, however, may not only compromise the reputation of the issuer, but may expose it to legal liability as well.<sup>119</sup>

This rationale behind Rule 3.10 of the ISP98 is not convincing and the approach taken in Article 17 of the URDG is to be preferred. Merely informing the applicant that a presentation has been made does not prevent the issuer from paying the standby. Placing such a duty on the issuer will merely allow the applicant to approach a court for the appropriate relief (i.e., application for an injunction (or interdict as it is known in the South African law) sooner, thereby enabling the applicant, for instance, to attach (by way of a *Mareva*-type injunction (or anti-dissipation interdict under the South African law)) the money before it is used by the beneficiary. Including such a duty in ISP98 would help in preventing fraudulent or abusive calls on standbys.

### The Convention

From 1988 to 1995 UNCITRAL<sup>120</sup> worked on a Uniform Law on International Guaranty. This eventually resulted in the drafting of the

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<sup>117</sup> *Id.*

<sup>118</sup> *Id.*

<sup>119</sup> *Id.*

<sup>120</sup> In 1966, the United Nations created UNCITRAL because it desired to play a more active role in reducing and removing legal obstacles to the flow of international trade. UNCITRAL's aim is to further the progressive harmonisation and unification of the law of international trade and its mandate is to be the main legal body in the field of international trade law within the United Nations system. UNCITRAL was initially composed of 29 states, but was expanded in 1973 to 36 states by a General Assembly resolution. Membership is structured so that a specified number of seats are allocated to each of the various geographic regions. Therefore, UNCITRAL is an intergovernmental body of the



Convention.<sup>121</sup> UNCITRAL adopted this Convention and opened it for signature by the General Assembly by its resolution 50/48 of 11 December 1995.<sup>122</sup> States were given a two-year period to sign the Convention, whereafter they had to accede to it. The Convention could only come into effect after it had been ratified by five states. Furthermore, in terms of Article 28 of the Convention, it could also only enter into force on the first day of the month following the expiration of one year from the deposit of the fifth instrument of ratification. As a result of this, the Convention only came into effect on 1 January 2000.<sup>123</sup>

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General Assembly that prepares international commercial law instruments designed to assist the international community in modernising and harmonising laws dealing with international trade. Various legal instruments have since been prepared by UNCITRAL. See UNCITRAL, Explanatory note by the UNCITRAL Secretariat on the United Nations Convention on Independent Guarantees and Stand-by Letters of Credit, cmt. 1, n.2 U.N. Doc. A/CN.9/431 (July 4, 1996), available at <http://daccessods.un.org/TMP/9645256.html> [hereinafter Explanatory Note]; but cf. Mara E. Trager, *Towards a Predictable Law on International Receivables Financing: The UNCITRAL Convention*, 31 N.Y.U.J. INT'L L. & POL. 611, 614-615 (1999).

<sup>121</sup> For a discussion of the background to the Convention and a discussion of a previous draft of this Convention, see E. E. Bergsten, *A New Regime for International Independent Guarantees and Stand-by Letters of Credit: The UNCITRAL Draft Convention on Guaranty Letters*, 27 INT'L LAW. 859 (1993). For a further legislative history of the UNCITRAL Convention, see James E. Byrne, *The International Standby Practices (ISP98): New Rules for Standby Letters of Credit*, 32 UCC L. J. 149, 150-151 (Fall 1999) (focusing on the authorities cited in note 2); Norbert Horn, *The U.N. Convention on Independent Guarantees and the Lex Mercatoria*, in GERMAN BANKING L. & PRAC. IN INT'L PERSPECTIVE 189 n.2 (Walter de Gruyter ed., Gmbh & Co. 1999).

<sup>122</sup> See The UNCITRAL Explanatory Note, *supra* note 120, cmt 1. For a full discussion of the Convention, see Lars Gorton, *Draft UNCITRAL Convention on Independent Guarantees*, J. BUS. L. 240 (May 1997); Dolan, *supra* note 10, at 1; De Ly, *supra* note 81; Horn, *supra* note 121, at 189.

<sup>123</sup> As of 1 November 2010, eight nations have ratified or acceded to the Convention: Belarus, Ecuador, El Salvador, Gabon, Kuwait, Liberia, Panama and Tunisia. The United States of America has signed the Convention but has not yet ratified it or acceded to it. United Nations Treaty Status Database ch. X § 15, <http://treaties.un.org/doc/Publication/MTDSG/Volume%20I/Chapter%20X/X-15.en.pdf> (last visited Nov. 1, 2010). In order for the US to ratify the Convention, it will require the advice and consent of the US Senate. After many years of inaction, there are now signs that the US might possibly ratify the Convention soon. Recently a delegation from the Uniform Law Conference of Canada met with a delegation from Mexico and delegates invited by the National Conference of Commissioners on Uniform State Laws (NCCUSL), the organisation that oversaw the drafting of the Article 5 of the American UCC, to discuss the implementation of the Convention in North America. NCCUSL, Mexico and Canada all expressed interest in adopting the Convention. See *2008 Annual Survey of Letter of Credit Law and Practice*, Publ'n No. 967 13 (J. E. Byrne & C. S. Byrnes, eds. 2008). For a discussion on what the

In view of the URDG, it may at first sight appear to be strange that UNCITRAL has invested such time and effort in producing its own Convention dealing with demand guarantees and standby letters of credit.<sup>124</sup> The reason for this is historical. Soon after UNCITRAL began to look at demand guarantees, the ICC embarked on its project to formulate a set of demand rules, the URDG, intended to be more accommodating of prevailing practice than the URDG. Thereupon, UNCITRAL agreed to stop further work and to abide by the ICC project. Unfortunately, this proceeded slower than had been anticipated and when, after the lapse of a number of years, it showed no signs of reaching finality, UNCITRAL justifiably decided to proceed with its own proposals for a convention or uniform law.<sup>125</sup> By the time the ICC got back on track with the URDG, the UNCITRAL project was considered too far advanced to be abandoned. Furthermore, being a work designed to lead either to a convention or to a uniform law capable of adoption in national legislation, it was able to deal with matters that could not properly be the subject of contractually incorporated rules, particularly the effect of fraud and the granting of interim injunctive relief.<sup>126</sup>

### **Application and Force of the Convention**

The Convention applies to an international undertaking such as a demand guarantee or a standby letter of credit, (1) where the place of business of the guarantor/issuer at which the undertaking is issued is in a contracting state<sup>127</sup> or (2) the rules of private law lead to the application of

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position under the letter of credit law will be in the United States if the Convention is adopted by the United States, *see* Paul S. Turner, *The United Nations Convention on International Standby Letters of Credit: How Would It Change Existing Letter of Credit Law in the United States?*, 114 *BANKING L.J.* 790 (1997). The Secretariat for UNCITRAL has explained the main objectives of the Convention. *See generally*, Explanatory Note, *supra* note 120.

<sup>124</sup> See Roy Goode, *Abstract Payment Undertakings in International Transactions*, XXII *BROOK. J. INT'L L.* 1, 19 (1996) [hereinafter *International Transactions*].

<sup>125</sup> *Id.*

<sup>126</sup> *Id.*

<sup>127</sup> The Convention, *supra* note 5, art. 1(1)(a). As of Nov. 15, 2010 the Convention will apply to international undertakings (demand guarantees or standby letters of credit) issued by banks in Belarus, Ecuador, El Salvador, Gabon, Kuwait, Liberia, Panama and Tunisia.

the law of a contracting state,<sup>128</sup> unless the undertaking excludes its application. The Convention can also apply to commercial letters of credit if the parties expressly state that their credit is subject to it.<sup>129</sup>

Article 2(1) of the Convention describes the type of undertaking regulated by it in the following terms:

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.<sup>130</sup>

Article 2 of the Convention concerns an undertaking that “is an independent commitment.” The independence (autonomy) of the undertaking is of basic importance for the applicability of the Convention and Article 3 describes the independence of the undertaking as follows:

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 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 not appearing in the undertaking, or to any future, uncertain act or

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<sup>128</sup> *Id.* art. 1(1)(b). For instance, the Convention will apply to international undertakings (demand guarantees or standby letters of credit) if a court determines the law of Belarus, Ecuador, El Salvador, Gabon, Kuwait, Liberia, Panama and Tunisia is the applicable law.

<sup>129</sup> *Id.* art. 1(2).

<sup>130</sup> *Id.* art. 2(1).

event except presentation of documents or another such act or event within a guarantor/issuer's sphere of operations.<sup>131</sup>

From the above, it is clear that ancillary undertakings, such as suretyships, are specifically excluded from the Convention.

It was decided that the application of the Convention should be limited to international undertakings (demand guarantees/standby letters of credit), in particular, since it was felt that the inclusion of domestic instruments would adversely affect the global acceptability of the Convention.<sup>132</sup> Article 4 defines what is meant by "international character of the undertaking."<sup>133</sup> According to Article 4(1), an undertaking is international if the places of business (or residence) specified in the undertaking of any two of the following persons are in different states (countries): guarantor/issuer, beneficiary, principal/applicant, instructing party or confirmer. Therefore, the Convention extends only to independent undertakings that are international in origin.<sup>134</sup>

The Convention is shaped round both the UCP and the URDG, but it is distinctive in that both the UCP and the URDG are drafted by the ICC, a private organisation, as voluntary rules or self-regulation, whereas the Convention is drafted by UNCITRAL, as a uniform law or official regulation for those countries who adopt it. Therefore, a state's adoption of the Convention has the effect of making it law in that state, in contrast to the URDG and other ICC rules, which take their force from incorporation into the contract of the parties.<sup>135</sup> The Convention, in addition to being essentially consistent with the solutions found in the rules of practice, supplements their operation by dealing with issues beyond the scope of such rules. It does so especially regarding the question of fraudulent or unfair demands for payment and judicial remedies available in such instances.<sup>136</sup>

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<sup>131</sup> *Id.* art. 3.

<sup>132</sup> Bergsten, *supra* note 121, at 863; *see also* De Ly, *supra* note 81, at 838.

<sup>133</sup> The Convention, *supra* note 5, art. 4; *see also* De Ly, *supra* note 81, at 838.

<sup>134</sup> Dolan, *supra* note 10, at 9.

<sup>135</sup> GUIDE TO THE URDG, *supra* note 10, at 7.

<sup>136</sup> Explanatory Note, *supra* note 120, cmt. 5.

In other words, because the legal status of the Convention is distinctive from the ICC rules, the Convention includes provisions relating to the fraud exception.<sup>137</sup> In its treatment of contractual relations between the parties, the Convention follows the URDG rather closely in scope and effect, although its drafting is fairly different and the Convention does not contain any equivalent of article 20 of the URDG.<sup>138</sup>

Since the adoption of the Convention no major trading nation has acceded, although the ICC has indicated its approval.<sup>139</sup> To date, South Africa has neither signed nor acceded to the Convention. It also seems that South Africa has no immediate plans to do so.

As mentioned above, the Convention is specifically designed to regulate demand guarantees and standby letters of credit, although commercial letter of credit users may also choose to use it if they so wish.<sup>140</sup> The most important articles of the Convention are found in Chapters IV and V, which concern the bank's payment obligation and the exceptions to this obligation. Contrary to the ICC rules of practice, the Convention made an attempt to address the issue of fraud and to prevent fraudulent or unfair calling of standby letters of credit and demand guarantees.<sup>141</sup> However, the terms "fraud" and "abuse of right" have not been used in the Convention in order to avoid possible confusion resulting from different (and inconsistent) interpretations already developed in various jurisdictions about the meaning of these terms. This was done especially since criminal law notions often influence the concept of fraud.<sup>142</sup>

In relation to the payment obligation, Articles 13 to 17 of the Convention determine that the bank must honour a payment demand if it meets the requirements in the demand guarantee/standby letter of credit.<sup>143</sup>

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<sup>137</sup> GAO, *supra* note 13, at 21.

<sup>138</sup> International Transactions, *supra* note 124, at 19.

<sup>139</sup> The ICC endorsed the UNCITRAL Convention on June 21, 1999. See ICC Publ'n No. 500/2 (2002) at 69.

<sup>140</sup> The Convention, *supra* note 5, art. 1(2).

<sup>141</sup> GAO, *supra* note 13, at 60.

<sup>142</sup> *Id.* at 60-61; Bergsten, *supra* note 121, at 872, 872 n.61; BERTRAMS, *supra* note 60, at 356.

<sup>143</sup> The Convention, *supra* note 5, arts. 13-17.

The bank is given a reasonable amount of time to examine the demand (a maximum of seven working days).<sup>144</sup>

In Article 15, the Convention first puts up a general requirement for the beneficiary demanding payment under a demand guarantee/standby letter of credit.<sup>145</sup> Article 15(3) of the Convention provides that “[t]he 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.”<sup>146</sup> In other words, Article 15(3) states that a beneficiary “is deemed to certify that the demand is not in bad faith” and that the demand is not fraudulent.

In terms of Article 17 of the Convention, the guarantor/issuer must, subject to Article 19, pay against a demand made in accordance with the provisions of Article 15. Article 18 spells out an exception due to the right of set-off and Article 19 contains certain exceptions in which cases the bank does not have to pay. In other words, payment under a demand guarantee/standby letter of credit has the potential to be disrupted if the elements listed in Article 19 exist in the demand/credit.<sup>147</sup>

From the viewpoint of unfair calls and the principle of autonomy, the vital articles of the Convention are Articles 15(3), 19 and 20. These articles work together to make it more difficult for an unfair call to succeed and they do so by seeking a justification for the call in the underlying contract.<sup>148</sup>

### **Fraud and the Convention**

The Convention also recognises exceptions to the absolute and independent nature of demand guarantees and standby letters of credit. Article 19, under the heading “Exception to Payment Obligation” stipulates

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<sup>144</sup> *See Id.* art. 16(2).

<sup>145</sup> *See id.* art. 15.

<sup>146</sup> *Id.*

<sup>147</sup> GAO, *supra* note 13, at 61.

<sup>148</sup> Debattista, *supra* note 9, at 297.

the circumstances under which the issuer/guarantor may dishonour the beneficiary's demand for payment. Article 19(1) reads as follows:

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,<sup>149</sup> has a right, as against the beneficiary, to withhold payment.<sup>150</sup>

Paragraph (2) of Article 19 explains what the term "no conceivable basis" referred to in subparagraph (c) of paragraph (1) means. It provides that 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 satisfaction of the beneficiary;
- (d) Fulfilment of the underlying obligation has clearly been prevented by wilful misconduct of the beneficiary;

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<sup>149</sup> See The Convention, *supra* note 5, art. 14(1) (imposing on the guarantor/issuer a duty to act in good faith and exercise reasonable care having due regard to generally accepted standards of international practice of standby letters of credit/demand guarantees in discharging its obligations under the undertaking and under the Convention.).

<sup>150</sup> *Id.* art. 19(1).

- (e) 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.<sup>151</sup>

For the first time the Convention contains a codification of the different situations where fraud is present and it too requires strong evidence of this.<sup>152</sup> This list may not be exhaustive, but it is a remarkable and encouraging way in which to define the kind of misconduct that may provoke the fraud exception. It unquestionably stands as the most detailed provision so far to clarify the misconduct that may bring the fraud exception into operation.<sup>153</sup> This definition of unfair calling and the acknowledgment of a legal defence are embedded in a more general codification of exceptions to the payment obligation in Article 19 of the Convention. This situation of unfair calling is generally described in Article 19(1)(c) as “judging by the type and purpose of the undertaking, the demand has no conceivable basis.” Accordingly, this is then more specifically described by five cases set out in Article 19(2).<sup>154</sup>

Article 19 deliberately avoids the terms “bad faith,” “abuse,” and “fraud,”<sup>155</sup> since they have confusing and inconsistent meanings in the different legal systems and are often influenced by criminal law notions of malicious intent, which are not suitable in relation to guarantees.<sup>156</sup>

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<sup>151</sup> *Id.* art. 19(2).

<sup>152</sup> *Id.* art. 20(1) (implying that the courts may issue provisional measures on the basis of “strong evidence” of the presence of fraud); Horn, *supra* note 121, at 200-201.

<sup>153</sup> GAO, *supra* note 13, at 97.

<sup>154</sup> Horn, *supra* note 121, at 200–201.

<sup>155</sup> Bergsten, *supra* note 121, at 872.

<sup>156</sup> *Id.* at 872, n.61. See also Jean Stoufflet, *10th Biennial Conference of The International Academy of Consumer and Commercial Law: International Banking Developments: Fraud in Documentary Credit, Letter of Credit and Demand Guaranty*, 160 DICK. L. REV. 21, 25 (2001) (“Practitioners within the industry know that some letters of credit or guaranties are fraudulent, having been issued either by swindlers, claiming to be first-class banks, or by insolvent issuers. Such behavior is unseemly and blameworthy, however, it is not really characteristic. More typical is a fraudulent demand for payment by the beneficiary of a letter of credit or demand guaranty . . . [t]here are strong reasons for courts to look objectively at fraud in transactions involving documentary credits, stand-by letters of credit



Therefore, Article 19(1) of the Convention has instead employed the general formula of a demand for payment that “has no conceivable basis,” while paragraph (2) of Article 19 also shows that the impropriety of the demand may relate, or could be determined by reference to, the underlying transaction.<sup>157</sup> As far as the degree of proof is concerned, fraud must be “manifest and clear” and “immediately available.”<sup>158</sup> The Convention is mainly concerned with the nature of the documents presented. It does not mention, and is not concerned with, the identity of the fraudulent party. Therefore, the fraud exception applies under the Convention if “any document is not genuine or has been falsified” regardless of the identity of the fraudster.<sup>159</sup> Furthermore, although the Convention requires “manifest and clear” evidence to invoke the fraud exception, it does not mention that the wrongdoer’s intention should be proven.<sup>160</sup> From reading the provisions of the Convention, it seems that the Convention, like Revised UCC Article 5-109, focuses rather on the nature of misconduct than the fraudster’s state of mind or the identity of the fraudster.<sup>161</sup>

The Convention does not place an express duty on the guarantor to refuse payment under certain circumstances, but only a right to do so.<sup>162</sup> Article 19 seems to allow the guarantor/issuer certain discretion when payment is demanded, but it also implies a certain duty on him to make a judgement whether the requirements are met or not. The article therefore allows for certain objections of payment under certain circumstances and they seem to go further than the limits that have developed in case law. The most significant part is perhaps that there now appears to be a certain duty on the guarantor to make a judgement call as to whether payment should be made.<sup>163</sup> Whether the enumerated causes giving right to a refusal to pay are

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and demand guaranties. It should not be necessary to prove that the beneficiary had malicious intent or that the beneficiary acted in bad faith.”).

<sup>157</sup> Explanatory Note, *supra* note 120, cmts. 46-47.

<sup>158</sup> The Convention, *supra* note 5, arts. 19-20. *See also* BERTRAMS, *supra* note 60, at 356.

<sup>159</sup> The Convention, *supra* note 5, art. 19(1)(a). *See also* GAO, *supra* note 13, at 117.

<sup>160</sup> The Convention, *supra* note 5, art. 19(1).

<sup>161</sup> GAO, *supra* note 13, at 97, 117.

<sup>162</sup> The Convention, *supra* note 5, art. 19(1) (stating that if the presence of fraud is “manifest and clear ... the guarantor/issuer, acting in good faith, *has a right*, as against the beneficiary, to withhold payment ...”) (emphasis added).

precise and clear enough is something that will have to be resolved in future case law, but the ground is certainly laid for a narrowing down of the independence of the demand guarantee.<sup>164</sup>

The exception set out in Article 19(1)(b) includes the so-called literal defences—the defences available that stem from the text of the demand guarantee/standby letter of credit and that the bank can use against the beneficiary.<sup>165</sup> With the exception stipulated in Article 19(1)(c), the Convention has formulated a general definition of the fraud exception. In view of the fact that in different countries various descriptions are given of the circumstances under which it is possible to reject payment under a demand guarantee/standby letter of credit (i.e., fraud, abuse of rights, and manifestly unreasonable demand), the decision was made to use a general formulation of the fraud exception.<sup>166</sup> The downside of this open formulation is that judges from various contracting states could interpret this provision in different ways. However, the risk has been reduced to some degree by the examples of the grounds for denying payment given in Article 19(2).<sup>167</sup>

However, two aspects of Article 19 depart quite clearly from the principle of autonomy.<sup>168</sup> First, in determining whether a call is justified, Article 19(1)(b) and (c) and 19(2)(a), (b), (c) and (d) all require the guarantor/issuer of the demand guarantee/standby letter of credit to look to the underlying contract for good cause to pay. Second, by constantly insisting on the exercise of good faith, Article 15(3), the tailpiece of Article 19(1) and Article 19(2)(e) put both the beneficiary and the guarantor/issuer of the guarantee/letter of credit on notice that payment needs to be justifiable by good cause.<sup>169</sup>

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<sup>163</sup> Explanatory Note, *supra* note 120, cmt. 48 (“entit[les] but not impos[es] a duty on the guarantor/issuer, as against the beneficiary, to refuse payment when confronted with fraud or abuse ... allowing discretion to guarantor/issuer acting in good faith”).

<sup>164</sup> Gorton, *supra* note 122, at 249.

<sup>165</sup> De Ly, *supra* note 81, at 842.

<sup>166</sup> Explanatory Note, *supra* note 120, cmt. 46.

<sup>167</sup> De Ly, *supra* note 81, at 842-843.

<sup>168</sup> *Id.* at 842.

<sup>169</sup> Debattista, *supra* note 9, at 298.

Viewed in context of ICC rules, it is clear that the Convention represents a step back from the URDG and towards the URCG. Under the Convention, a demand is not in itself sufficient to trigger payment.<sup>170</sup> A simple declaration that payment is due under the underlying contract is also not sufficient: the demand needs to be justified in good faith within the context of the underlying contract. Despite the declaration of the principle of independence in Article 3 of the Convention,<sup>171</sup> when it comes to examining the validity of a claim (call), the veil separating the guarantee (or standby letter of credit) from the underlying contract is well and truly discarded.<sup>172</sup>

Article 19 not only provides the guarantor/issuer with some basis for refusing payment, but also enables the principal to take court measures against a fraudulent beneficiary.<sup>173</sup> Paragraph (3) of Article 19 states that “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.”<sup>174</sup> Article 20 of the Convention, under the heading “Provisional Court Measures,” then stipulates the measures a court can take by providing:

- (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:

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<sup>170</sup> *Id.*

<sup>171</sup> The Convention, *supra* note 5, art. 3 (describing an independent guarantee (demand guarantee) to which the Convention applies as one that is not dependent on the underlying contract or subject to any term not appearing in the undertaking itself). However, it has been said that the effect of this article is to describe the demand guarantees/standby letters of credit (undertakings) to which the Convention is to apply, not to establish the principle of autonomy in the context of demand guarantees. *See* Debattista, *supra* note 9, at 298.

<sup>172</sup> *Id.*

<sup>173</sup> Explanatory Note, *supra* note 120, cmt. 49.

<sup>174</sup> The Convention, *supra* note 5, art. 19(3).

- (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 therefore 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.<sup>175</sup>

Article 20 of the Convention makes provision both for measures similar to an injunction (i.e., an interdict under the South African law) preventing payment and for attachment or *Mareva*-type injunctions (freezing orders or anti-dissipation interdicts as they are known in the South African law)<sup>176</sup> to be available to the court where there is a “high probability” shown by “immediately available strong evidence”;<sup>177</sup> the court “may issue a provisional order” or similar.<sup>178</sup> Although the exact meaning

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<sup>175</sup> The Convention, *supra* note 5, art. 20.

<sup>176</sup> For a brief discussion of the South African anti-dissipation interdict, *see* Kelly-Louw, *supra* note 63, at 426-428.

<sup>177</sup> Charles F. Hugo, *The Law Relating to Documentary Credits from a South African Perspective with Special Reference to the Legal Position of the Issuing and Confirming Banks* 309 (University of Stellenbosch Printers 1997).

<sup>178</sup> In *BC Ltd. v. KPMG Inc.* [2004] 238 D.L.R. 13 (Can.), a Canadian court concluded that a drawing on a letter of credit where there was no breach of the underlying contract would be abusive and within the concept of fraud. *See* James E. Byrne, *Case Summary of BC Ltd. v. KPMG Inc.*, in 2005 ANNUAL SURVEY OF LETTER OF CREDIT LAW AND PRACTICE 260-62 (James Byrne, ed. 2005). The view has been expressed that this case is on the edge of what is fraud and it was decided correctly. (This view was expressed by one of the panellists (it

of the two crucial phrases, namely, “high probability” and “immediately available strong evidence” will have to be determined by the courts in the different jurisdictions, Hugo has indicated that it appears that one may conclude that the position of the bank’s customer would in most jurisdictions be significantly better under the Convention than under the prevailing law.<sup>179</sup>

Notably, neither the UCP nor the URDG contain any provisions on court procedure. This is rather obvious taking into consideration the contractual/custom status of the UCP and the URDG. In recent years various national courts and/or legislators have established provisional court measures (such as injunctions in Anglo-American law), allowing the applicant to request provisional court interference to prevent the payment to the beneficiary under a letter of credit/demand guarantee under certain circumstances.<sup>180</sup>

Article 19 of the Convention codifies the exception of fraud, in particular the cases in which the bank does not have to pay (however, payment is permitted).<sup>181</sup> This article is immediately attached to the right of the principal to petition the court in the case of fraud and to invoke his rights, which are set out in Article 20.<sup>182</sup> Accordingly, Articles 19 and 20 provide respectively for the definition and description of the fraud exception, and the measures available to the principal in such case.<sup>183</sup>

Xiang Gao indicates that these provisions of the Convention are clear and narrow in scope, and provide an exceptional international

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is uncertain from which jurisdiction he or she was) during the 2005 Annual Survey of Letter of Credit Law & Practice, held by the Institute of International Banking Law and Practice in Miami, Florida on 17-18 March 2005. Boris Kozolchyk, adding to this, indicated that that case clearly demonstrated the value of the Convention in helping to protect against abusive drawings.) See James Byrne, Annual Survey of Letter of Credit Law & Practice Supplemental Materials 50 (March 2005) (unpublished manuscript, on file with the Institute of International Banking Law and Practice).

<sup>179</sup> HUGO, *supra* note 177, at 309.

<sup>180</sup> Gorton, *supra* note 122, at 251.

<sup>181</sup> Explanatory Note, *supra* note 120, cmt. 46.

<sup>182</sup> The Convention, *supra* note 5, art. 19(3).

<sup>183</sup> See De Ly, *supra* note 81, at 842.

standard.<sup>184</sup> He points out that these provisions will undoubtedly provide good guidance for courts to enhance their application of the fraud exception.<sup>185</sup> He is also of the view that these provisions are generally in accordance with the current practice. They include most of the elements of the fraud exception that have been developed over the years by national courts (e.g., American and English courts) and/or legislators, and provide a detailed and helpful guide to users of demand guarantees and the courts. Furthermore, he states that like the United States Revised UCC Article 5-109(b), the Convention<sup>186</sup>

- (1) has clearly indicated what kind of actions victims of fraud may take when fraud is “manifest and clear” in a transaction of demand guarantees/standby letters of credit, namely the guarantor’s/issuer’s dishonour of a presentation or withholding payment,<sup>187</sup> and the principal’s/applicant’s entitlement to a court injunction preventing the honouring of a presentation by the guarantor/issuer;
- (2) has listed what kind of misconduct may invoke the fraud exception;<sup>188</sup>
- (3) has specified that either fraud in the documents or fraud in the underlying contract may invoke the fraud exception;<sup>189</sup> and
- (4) has provided necessary guidelines for courts considering the application of the fraud exception.<sup>190</sup>

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<sup>184</sup> Buckley & Gao, *supra* note 1, at 333 (citing *Litigation Digest: Agritrade Int'l Pte. Ltd v. Industrial & Commercial Bank of China*, [1998] 3 S.L.R. (Singapore), 4(3) DOCUMENTARY CREDIT WORLD 8, 12 cmt. 1 (2000)).

<sup>185</sup> See GAO, *supra* note 13, at 97 (citing *Litigation Digest: Agritrade Int'l Pte. Ltd v. Industrial & Commercial Bank of China*, [1998] 3 S.L.R. (Singapore), 4(3) DOCUMENTARY CREDIT WORLD 8, 13 (2000)).

<sup>186</sup> See GAO, *supra* note 13, at 62-63.

<sup>187</sup> See The Convention, *supra* note 5, art. 19(1)(c).

<sup>188</sup> See *Id.* art. 19.

<sup>189</sup> See *Id.* art.19(1)(a), (c).

<sup>190</sup> See *Id.* art. 20.

It has been said that the regulation of the fraud exception in Article 19 is a success both politically and technically.<sup>191</sup> Politically, a uniform and mandatory concept of fraud avoids regulatory competition between different legal systems and therefore between the banking industries of various countries, concentrating competition on the terms and prices of the banking products and not on regulatory issues.<sup>192</sup> Technically, the somewhat open-ended formulation of the fraud exception has avoided the exercise of reaching an agreement on the concept of fraud in various national legal systems. Moreover, the description of fraud is strong enough so that payment as a rule remains, while refusal to pay is an exception. Apparently, the examples in Article 19(2) make the rule sufficiently clear. However, an open and uniform description has the disadvantage that judges in contracting states will interpret this concept differently.<sup>193</sup> This often happens when one is dealing with a uniformed text (e.g., a convention) that does not provide for an international court to decide in a binding way how uniform law is to be interpreted. It is possible though to control this risk, if there is sufficient information available in other countries regarding the interpretation of the unifying text. As already mentioned, UNCITRAL has developed a databank that contains court decisions on unifying texts. It also publishes summaries of recent decisions.<sup>194</sup>

Many countries—including South Africa, England and the United States—authorise the courts to grant an order (i.e., an interdict or injunction) enjoining the guarantor/issuer from paying or enjoining the beneficiary from receiving payment under a demand guarantee/standby letter of credit. In Article 20 of the Convention legal remedies are provided that a principal/applicant can make use of to prevent payment under a demand guarantee/standby letter of credit. It seems that the text of Article 20 suggests that provisional rather than final measures are intended. In various countries summary proceedings (such as injunctive relief) are interpreted as provisional measures and therefore it is doubtful that (conserving) attachment orders would fall under Article 20. In this regard it has been said that the text of Article 20, the requirements of provisional measures and the

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<sup>191</sup> De Ly, *supra* note 81, at 843-44.

<sup>192</sup> For a contrary view, *see* Dolan, *supra* note 10, at 16-21 (arguing that fraud should be left to be governed by the domestic law of mature letter of credit and bank demand guarantee jurisdictions).

<sup>193</sup> De Ly, *supra* note 81, at 842.

<sup>194</sup> *Id.* at 843.

cases in which provisional measures can be employed are arguments for keeping “attachment orders” and similar (final) measures outside of the Convention.<sup>195</sup> In terms of the Convention, the principal can request provisional measures under which the beneficiary will not receive payment (including the bank putting the funds into an escrow account) or in which the beneficiary’s funds are blocked. This is only possible under the exceptions listed in Article 19 and if the demand guarantee/standby letter of credit is used for a criminal purpose.<sup>196</sup> In terms of procedural law, provisional measures have been given extra guarantees to prevent them from being accepted too often. Most of all, the principal must present the circumstances set out in Article 19 in a manner in which *prima facie* evidence is insufficient, as “immediately available strong evidence” is required. The judge may only allow provisional measures if there is a “high probability” that the circumstances set out in Article 19 exist and it may be taken into account that the account party is “likely to suffer serious harm” if no provisional measure is taken.<sup>197</sup> Therefore, it appears that Article 20 is not an open invitation for the judge to interfere. The view has been expressed that with regard to provisional measures, the Convention is strict enough with principals/applicant while still being flexible enough to permit the application of provisional measures in exceptional cases.<sup>198</sup>

However, the Convention does not provide the principal/applicant with the highest degree of protection from fraud. In the URCG the principal is protected by the requirement, set out in Article 9, that a document is provided that proves default, while Article 20 of the URDG requires that a demand for payment state the reasons.<sup>199</sup> Under Article 15(3) of the Convention none of this is required, and the Convention limits itself to the statement that the beneficiary is considered to have judged whether or not the demand is made in good faith and whether the exceptions set out in article 19(1) apply.<sup>200</sup> It has been said that the weakness contained in the article regarding the beneficiary’s examination of his own conscience will in practice in cases of fraud prove to be meaningless and ineffective in

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<sup>195</sup> See *id.*

<sup>196</sup> *Id.*

<sup>197</sup> *Id.*

<sup>198</sup> See *id.* at 843-844.

<sup>199</sup> *Id.* at 844-845; GAO, *supra* note 15, at 57-58.

<sup>200</sup> De Ly, *supra* note 81, at 845.



countering fraud. Furthermore, the practical difference between the URDG and the Convention in this perspective is not to be exaggerated; also the reasoned demand of payment by the beneficiary in many cases will not prevent fraud.<sup>201</sup>

It has also been stated that the Convention fraud rules are defensible from the viewpoint of banks and beneficiaries. However, the principal is left out in the cold if a demand for payment is made and the bank makes payment without notifying the principal.<sup>202</sup> The Convention does not place a duty on the bank to provide information and to wait a few days before payment is made so that in cases of fraud the principal is not in a legal position to take immediate action. Furthermore, the Convention would have achieved a better balance by including an obligation to provide information and to delay payment.<sup>203</sup> Only then would market participants have been able to choose between strong protection against fraud under the URDG, moderate protection under the Convention and minimal protection under the UCP. Moreover, in this regard the Convention is not inventive, is too closely aligned with the self-regulation of the URDG and UCP, and an important chance to correct the current situation was missed.<sup>204</sup>

It is true that the provisions relating to the fraud exception contained in the Convention signal a significant and encouraging development in this area of the law.<sup>205</sup> Furthermore, the Convention is the first document to provide details of the fraud exception at an international level. Another important issue is that, unlike the ICC rules, which have to be incorporated into the demand guarantee as contractual terms to be effective, the Convention becomes law in a country that signs and/or ratifies it.<sup>206</sup>

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<sup>201</sup> *Id.* at 844-845.

<sup>202</sup> *Id.* at 845.

<sup>203</sup> *Id.* at 845-846.

<sup>204</sup> *See id.*

<sup>205</sup> However, Dolan has criticised the inclusion of the provision of the Convention aimed at the prevention of fraudulent calls. He suggests that like the UCP, the UNCITRAL Convention should have left the question of fraud out of the Convention and should rather have left it to the domestic law of the different jurisdictions. In fact, according to him it would have been better if the Convention were never created. See Dolan, *supra* note 10, at 19-21, 23.

<sup>206</sup> GAO, *supra* note 15, at 61.

### **Conclusion**

Opinion on whether or not the UCP should deal with the fraud issue is divided. In my view, it is regrettable that the UCP, which have become such an important universal set of rules (source of law) are silent on the issue of unfair or fraudulent calling of letters of credit and standby letters of credit. What is even more regrettable is the fact that the UCP do not contain any provision on the guarantor's right to refuse payment.

ISP98 takes a similar approach to the UCP and expressly leave the issue of fraudulent or unfair calling of standby letters of credit to be determined by the applicable jurisdictional law. As with the UCP, it is also regrettable that the ISP98 is silent on this issue.

One of the objectives of the URCG was to limit the possibilities of unfair demands of guarantees issued under it. In terms of Article 9 of the URCG, if the guarantee did not specify the documentation to be produced in support of a claim or merely specified the submission of a statement of claim, the beneficiary was required to submit (1) in the case of a tender guarantee, the beneficiary's declaration that the guarantee was due and an agreement to have any dispute with the principal submitted to litigation or arbitration, and (2) 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 to the amount to be paid. However, in addition to limiting the possibility of improper demand, the requirements of Article 8(3)(b) read with Article 9 effectively eliminate the simple demand guarantee. Therefore, one of the major problems with respect to the URCG is that they did not take into consideration the increasing use and importance of on-demand (simple or first demand) guarantees.

Article 20 of the URDG458 does not go as far as Article 9 of the URCG. The article has gone some small way in placing restrictions on the beneficiary's right of payment. This article only requires that the demand be in writing and supported by a written statement that the principal is in breach of the underlying contract and in what respect the principal is in breach. The simple demand guarantee is thereby transformed into a documentary guarantee, with a required minimum content of the document. However, the wording used here is not a very effective safety device, but at least it places on the beneficiary a certain obligation to show his hand. The requirement that the beneficiary has to state in writing both that there is

some kind of breach of the underlying contract and the type of breach that is involved gives the principal limited protection. However, URDG458 does not contain any provision on the guarantor's right to refuse payment.

Therefore, although the URCG and URDG458 have both attempted to prevent unfair calls on demand guarantees, in conclusion, it can be said that neither set of rules seems quite sufficient. In fact, URDG458 has not only failed to win the support of all groups but have also been strongly opposed by some.

In the Convention, neither the approach of the URCG nor that of the URDG458 was taken. Contrary to the UCP and ISP98, the Convention made an attempt to address the issue of fraud and to prevent fraudulent or unfair calling of standby letters of credit and demand guarantees. From the viewpoint of unfair calls and the principle of autonomy, the vital articles of the UNCITRAL Convention are Articles 15(3), 19 and 20. These articles work together to make it more difficult for an unfair call to succeed and they do so by seeking a justification for the call in the underlying contract. The Convention specifically recognises exceptions to the absolute and independent nature of demand guarantees and standby letters of credit. Article 19 with the heading "Exception to Payment Obligation" stipulates the circumstances under which the issuer/guarantor may dishonour the beneficiary's demand for payment. Article 19(1) provides that if it is manifest and clear that (1) any document is not genuine or has been falsified; (2) no payment is due on the basis asserted in the demand and the supporting documents; or (3) 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. Article 19(2) then proceeds to listing the circumstances in which it will be considered that the demand has no conceivable basis. In addition to this, Article 20 recognises the possibility of restraining orders against the beneficiary and/or bank on the basis of immediately available strong evidence that the beneficiary's demand for payment has no conceivable basis, as described in Article 19(2).

The Convention for the first time contains a codification of the different situations where fraud is present, and it too requires strong evidence as to this situation. This list may not be exhaustive, but it is a remarkable and encouraging way in which to define the kind of misconduct that may provoke the fraud exception. Article 19 provides that as far as the degree of proof is concerned, the fraud must be "manifest and clear" and "immediately available." It clearly provides that appropriate fraud in the

narrow sense (e.g., fraud committed by the beneficiary on the documents) as well as broad sense (e.g., fraud committed by the beneficiary that does not relate to documents) will be sufficient to constitute an exception to the autonomy principle. In my view, it defines the concept of fraud a little too widely in Article 19(2). However, it unquestionably stands as the most thorough provision so far with regard to the clarification of the type of misconduct that may bring the fraud exception into operation.

However, it does seem that Article 19 departs quite clearly from the principle of autonomy. For instance, in determining whether a call is justified, most of the sub-articles of Article 19<sup>207</sup> require the guarantor/issuer of the demand guarantee/standby letter of credit to look to the underlying contract for good cause to pay. Article 19 does not place an express duty on the guarantor/issuer to refuse payment under certain circumstances, but only a right to do so. The article seems to allow the guarantor/issuer certain discretion when payment is demanded, but it also implies a certain duty on him to make a judgment whether the requirements are met or not. Therefore, there now appears to be a certain duty on the guarantor to make a judgment whether payment should be made. Banks understandably want to keep their involvement to a minimum when dealing with the question of whether or not to pay under a demand guarantee/letter of credit, particularly when there are allegations of fraud. It has been said that banks are objecting to the ratification of the Convention, because of their perception that Articles 15(3) and 19 will bring about their greater involvement.<sup>208</sup>

Articles 19 and 20 provide respectively for the definition and description of the fraud exception, and the measures available to the principal/applicant in such a case. However, the attempts made by the Convention by way of Articles 19 and 20 are commendable, especially since it is the first real international attempt to prevent unfair calls and to codify the fraud exception. However, the effectiveness of the Convention in this regard is seriously doubted.

Although the Convention already came into effect on 1 January 2000, it has so far been ratified (acceded to) by only a few countries. The

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<sup>207</sup> See The Convention, *supra* note 5, art. 19(1)(b)-(c), 19(2)(a)-(d).

<sup>208</sup> See Roger Fayers, *Developments Concerning the "Accounting Principle"*, 12 DCINSIGHT 18, 20 (Oct.-Dec. 2006).

United States signed the Convention on 11 December 1997, but has yet to accede to it. Therefore, no major trading country has thus far ratified it. It would also appear that South Africa has no immediate future plans to adopt it either. From this it appears that the success of the Convention has been rather limited. The reasons for this could be numerous. However, from a critical point of view, it is possible that the codified fraud exception might be one of the reasons for countries being hesitant to adopt it. Therefore, the fraud exception may possibly need further improvement. However, viewed politically, it seems to be rather impossible to do. Banks, in general, apparently also oppose the adoption of the Convention. They justifiably want to keep their involvement as far as demand guarantees/standby letters of credit are concerned to a minimum, and it is their opinion that the Convention, particularly Articles 15(3) and 19, would bring about their greater involvement.

It follows that if market participants want strong protection against fraud, they should incorporate the URCG; if they desire moderate protection, they should incorporate the Convention; and if they only want minimal protection, they should incorporate the URDG.

It is also clear that none of the rules of practice or the Convention has really succeeded in preventing fraudulent and unfair calls being made. Banks need a simple device in terms of which they will have to pay without having to make difficult considerations and to take hard decisions based on unclear evidence. Beneficiaries need a device in terms of which they get paid against a simple demand or against a simple document without risking various obscure objections. Principals/applicant, however, are interested in having some safety mechanism in the system so as to prevent unfair callings. Although the international initiatives, discussed above, are praiseworthy, they are unlikely to bring about a clear and practical solution to the problem of unfair calls, given the opposing nature of commercial and political interests and motives. The problem with all of these international initiatives, is that their effectiveness is limited to the extent to which the international community is prepared to adopt them in practice.

**Nothing Is Over Until We Decide It Is: Is Article 11(1) of the UN  
Standby Convention a Complete List of Ways to End the Beneficiary's  
Right to Demand Payment?**

Hilary Taylor\*

**Introduction**

Article 11(1) of the United Nations Convention on Independent Guarantees and Standby Letters of Credit<sup>1</sup> (the Convention<sup>2</sup>) lists four instances where the beneficiary's right to demand payment on a letter of credit ceases: (1) when the guarantor/issuer receives a statement from the beneficiary releasing it from liability; (2) when the guarantor/issuer and beneficiary have agreed on the termination of the undertaking; (3) when the amount available under the undertaking has been paid; and (4) when the validity period of the undertaking expires.<sup>2</sup> The question arises: is this list intended to be exclusive? Since Article 11(1) fails to include provisions for cessation in certain cases (including transfer of drawing rights, force majeure clauses, and fraud); other articles in the Convention refer to instances leading to either a discharge of or an exception to payment obligations; and the United Nations Commission on International Trade Law (UNCITRAL)'s Working Group on International Contract Practices' (Working Group) drafting notes for the Convention all imply other possibilities for ending a beneficiary's right, this paper concludes that the list is not exclusive.

In explaining this conclusion, I will consider the text of Article 11(1), drawing on other prominent documents in the field of letters of credit (LCs), including the International Standby Practices (ISP98)<sup>3</sup>, the Uniform

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<sup>1</sup> United Nations Convention on Independent Guarantees and Standby Letters of Credit, U.N. Doc. A/RES/50/48 (Dec. 11, 1995), *available at* <http://www.uncitral.org/pdf/english/texts/payments/guarantees/guarantees.pdf> [hereinafter The Convention].

<sup>2</sup> *Id.* art 11(1).

<sup>3</sup> *The International Standby Practices 1998 (ISP98)*, International Chamber of Commerce [ICC] Publ'n No. 590 (Jan. 1, 1999) [hereinafter ISP98].

Customs and Practice (UCP600)<sup>4</sup> and Revised Article 5 of the Uniform Commercial Code (UCC)<sup>5</sup> to clarify definitions of key terms, in addition to the Working Group's notes compiled while drafting the Convention. Finally, I will detail conduct and circumstances that are not addressed in Article 11(1).

**I. Establishing the Parameters: The Purpose of the Convention and the First Sentence of Article 11(1)**

Article 11(1) of the Convention states that:

“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.”<sup>6</sup>

UNCITRAL drafted the Convention in order to “facilitate the use of independent guarantees and stand-by letters of credit”<sup>7</sup> by stating commonly

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<sup>4</sup> The Uniform Customs and Practice for Documentary Credits (UCP600), ICC Publ'n No. 600 (July 1, 2007) [hereinafter UCP600].

<sup>5</sup> U.C.C. art. 5 (1995), available at <http://www.law.cornell.edu/ucc/5/overview.html>.

<sup>6</sup> The Convention, *supra* note 1, art. 11(1).

<sup>7</sup> See United Nations Commission on International Trade Law [UNCITRAL], Explanatory note by the UNCITRAL Secretariat on the United Nations Convention on Independent Guarantees and Stand-by Letters of Credit cmt. 2, U.N. Doc. A/CN.9/431 (July 4, 1996), available at <http://daccess-ods.un.org/TMP/9645256.html> [hereinafter Explanatory Note].

recognized basic principles for these instruments to “provide greater legal certainty in their use.”<sup>8</sup> As the Convention applies solely to international undertakings (more specifically, ones that do not specifically exclude its application)<sup>9</sup> it has been drafted carefully to work in conjunction with different LC laws in a wide variety of countries. For our purposes, a few specific terms used in the Convention—as well as its silence on certain issues—are of paramount importance in understanding its application.

With this in mind, the introductory sentence of Article 11(1), “The right of the beneficiary to demand payment under the undertaking ceases when,”<sup>10</sup> defines the scope of the four subsections that follow by its use of three key terms.

### A. Beneficiary

While the Convention loosely defines the other parties involved in the letter of credit transaction, it never defines “beneficiary.”<sup>11</sup> Although the Convention’s drafters noted early on that this was a problem, stating that “[a]nother point in need of clarification is who exactly is covered by the term ‘beneficiary,’” the final document fails to address this concern.<sup>12</sup> While it can be argued that the term is left intentionally broad in order to encompass complex transactions and relationships between parties, the lack of a defined term is occasionally problematic. For example, given the singular use of “the beneficiary” in Article 11(1), it is unclear what occurs in situations that the Working Group discussed, where “the original guaranty letter [has] a number of beneficiaries,” or, if amendments to the LC are made subsequent to its issuance, where “other beneficiaries may have to be recognized, namely substitute beneficiaries and beneficiaries by

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<sup>8</sup> *Id.* at cmt. 4.

<sup>9</sup> The Convention, *supra* note 1, art. 1(1).

<sup>10</sup> *Id.* art. 11(1).

<sup>11</sup> *Id.* art 2(1) (defining “guarantor/issuer” as “a bank or other institution or person,” with Article 6(a) expanding that definition to include “counter-guarantor” and “confirmer.” Article 2(2)(a) and (b) define the “principal/applicant” as the “customer”; and 2(2)(b) defines the “instructing party” as “a bank, person, or institution.”).

<sup>12</sup> UNCITRAL, Working Group on Int’l Trade Practices, Discussion of Further Issues of a Uniform Law: Amendment, Transfer, Expiry, Obligations of a Guarantor, Liability and Exemption, ¶ 8, U.N. Doc. A/CN.9/WG.II/WP.68 (July 31, 1990), available at <http://www.uncitral.org/pdf/english/yearbooks/yb-1991-e/vol22-p330-339-e.pdf>.



operation of law.”<sup>13</sup> Substitute beneficiaries and beneficiaries by operation of law will be covered *infra*, at section III (B)(1)(a).

In discussing the definition of “beneficiary,” the Working Group debated whether or not to expressly mention special categories of substitutes and transferees or “whether general rules of interpretation would lead to the conclusion that they were covered.”<sup>14</sup> To help bridge this gap, the definitions of “beneficiary” in other LC documents will help determine these general rules of interpretation.

Revised UCC Article 5 defines “beneficiary” as “a person who under the terms of a letter of credit is entitled to have its complying presentation honored. The term includes a person to whom drawing rights have been transferred under a transferable letter of credit.”<sup>15</sup> ISP98 provides a similar definition: “a named person who is entitled to draw under a standby,” adding that the term “includes a person to whom the named beneficiary has effectively transferred drawing rights.”<sup>16</sup>

Two things about these definitions are noteworthy. First, the term is not limited to a sole beneficiary, as any person who meets the requirements is eligible. Secondly, both definitions allow for drawing rights to be transferred.<sup>17</sup> The ability to transfer these rights is granted in the Convention’s Article 9, which states that “[t]he beneficiary’s right to demand payment may be transferred.”<sup>18</sup> While the Convention does not explicitly include multiple beneficiaries, its explicit approval of transfer strongly implies that it envisions multiple beneficiaries. After all, according to UCP600, the act of transferring credit (in whole or in part) creates two beneficiaries—the “first beneficiary,” who requests the transfer, and the “second beneficiary,” who receives the transfer.<sup>19</sup> Thus, if the Convention

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<sup>13</sup> *Id.*

<sup>14</sup> *Id.*

<sup>15</sup> U.C.C. § 5-102(a)(3) (1995).

<sup>16</sup> ISP98, *supra* note 2, R. 1.09(a), 1.11(c)(ii).

<sup>17</sup> The subject of transfer is discussed in more detail, see *infra* Part III(B)(1)(a).

<sup>18</sup> The Convention, *supra* note 1, art. 9.

<sup>19</sup> UCP600, *supra* note 4, art. 38(b), (d) (“A credit may be transferred in part to more than one second beneficiary provided partial drawings or shipments are allowed.”).

allows for transfer of a beneficiary's drawing rights, it should also allow for the creation of the multiple beneficiaries that will result from that transfer.

### B. Undertaking

As drafted, it is not obvious whether the Convention is intended to cover both commercial and stand-by letters of credit. Article 11(1) refers to “[t]he right of the beneficiary to demand payment under the undertaking.”<sup>20</sup> “Undertaking” is defined in Article 2 of the Convention as “an independent commitment, known in international practice as an independent guarantee or as a standby letter of credit.”<sup>21</sup> The Official Comments on the Convention clarify this point, stating that the Convention only covers standby LCs, although parties to commercial LCs have the right to “opt into” it.<sup>22</sup> Thus, while this discussion will focus on standby LCs, the Convention also provides a legal framework which may be applied to commercial LCs by agreement of the parties or as a model for local law.

### C. Ceases

The most important word in the first sentence of the Convention's Article 11(1)—“the right of the beneficiary to demand payment under the undertaking ceases when”—is “ceases,” as the finality of the term draws a distinction between events or instances which *end* the beneficiary's right and events or instances which *negatively impact* the beneficiary's right to demand payment.<sup>23</sup> While Article 11(1) is the only article in the Convention dealing with the cessation of the beneficiary's right to demand payment, several other articles mention instances in which the beneficiary's ability to collect payment is negatively impacted, including transfer, assignment, set-off, and fraud.<sup>24</sup> At first glance, since none of these instances were included in Article 11(1), it appears that they cannot constitute a complete loss of the beneficiary's right to repayment. However, after analyzing the Working

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<sup>20</sup> The Convention, *supra* note 1, art. 11(1).

<sup>21</sup> *Id.* art. 2. The definition section of the Convention adds: “‘Undertaking’ includes ‘counter-guarantee’ and ‘confirmation of an undertaking.’” *Id.* art. 6(a).

<sup>22</sup> Explanatory Note, *supra* note 7, cmt. 16.

<sup>23</sup> The Convention, *supra* note 1, art. 11(1).

<sup>24</sup> *Id.* arts. 9, 10, 18, and 19. While the word fraud is not specifically used, it is also referenced in Articles 15(3), 16(2)(b), and 20.

Group's notes regarding the drafting of both Article 11(1) and these other articles, it appears that certain types of transfers (including a transfer of an LC in its entirety) as well as some cases of fraud and set-off can also cease the beneficiary's right to payment.<sup>25</sup>

## II. Ending the Beneficiary's Right to Payment

### A. What Article 11(1) Explicitly Covers

#### 1. Paragraphs (a)-(c)

Paragraphs (a)-(c) of Article 11(1) are very straightforward, and require little explanation. Subsection (a) covers a statement by the beneficiary releasing the guarantor/issuer of liability in a form covered by Article 7(2) (which requires authentication by either generally accepted means or a procedure agreed to by the parties).<sup>26</sup> Paragraph (b) allows the beneficiary and the guarantor/issuer to agree on the termination of the undertaking, either as stipulated in that undertaking or subject to the same Article 7(2) form requirement.<sup>27</sup> Paragraph (c) ends the beneficiary's right because the guarantor/issuer has paid the amount available under the undertaking (unless the undertaking provides for automatic renewal or another form of continuation).<sup>28</sup>

In each of these situations, cessation requires an active step taken by the beneficiary—writing a letter, reaching an agreement with the guarantor/issuer, or making a presentation—in order to be valid.<sup>29</sup> Correspondingly, the guarantor/issuer must receive and read that notice, reach an agreement with the beneficiary, or make the payment.<sup>30</sup> As both parties are required to take some sort of action, some level of cognizance on both sides is required of the transaction, minimizing the potential for confusion.

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<sup>25</sup> See *infra* Part III.

<sup>26</sup> The Convention, *supra* note 1, arts. 7(2), 11(1)(a).

<sup>27</sup> *Id.* art.11(1)(b).

<sup>28</sup> *Id.* art. 11(1)(c).

<sup>29</sup> *Id.* art. 11.

<sup>30</sup> *Id.*

## 2. Paragraph (d)

Unlike the previous three paragraphs, under Article 11(1)(d), the beneficiary's right to demand payment under the undertaking ends based on the *inaction* of a party; specifically, when the validity period of the undertaking expires in accordance with Article 12.<sup>31</sup> Expiry can occur on a specified calendar date, the occurrence of an act or event outside the guarantor/issuer's control (along with presentation of a document and certification of that event's occurrence), or if neither of these is provided, six years from the date of issuance of the undertaking.<sup>32</sup> While the topic of customer renewal is not covered in 11(1)(d), 11(1)(c) notes that expiry may be avoided if the undertaking "provides for the automatic renewal or for an automatic increase of the amount available or otherwise provides for continuation of the undertaking."<sup>33</sup>

Having a time period instead of an explicit action that results in the cessation of a right creates several potential problems in the case of last-minute or late presentations by the beneficiary. For example, if the documents are lost in transmission prior to the first presentation, it is unclear which party bears the responsibility.<sup>34</sup> UCP600 states that banks assume no liability or responsibility for the loss in transit of any letters or documents if those letters or documents are sent according to the requirements established in the LC, but it is unclear whether this provision is echoed by the Convention.<sup>35</sup> The Working Group debated including very similar provisions in the Convention that would absolve guarantors of liability for the genuineness or sufficiency of documents; for any delay, difficulties caused by errors in translation, and/or loss in transit of documents; and for any of the events typically covered by a force majeure clause.<sup>36</sup> However, as no such provisions appear in the final version of the Convention, it is unclear whether the Working Group decided against

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<sup>31</sup> *Id.* art. 11(1)(d).

<sup>32</sup> *Id.* art. 12.

<sup>33</sup> *Id.* art. 11(1)(c), (d).

<sup>34</sup> *See* UCP600, *supra* note 4, art. 35. After presentation, however, the responsibility would lie with the party sending the documents. *Id.*

<sup>35</sup> *Id.* art. 35.

<sup>36</sup> UNCITRAL, *supra* note 12, at ¶ 65.

providing such protections, or decided that other documents (like UCP600) already provided that protection.

## **B. What Is Not Included in Article 11(1)**

As demonstrated by its constant cross-references (three of the four paragraphs in Article 11(1) reference other articles), the Convention is clearly designed to be read as a whole. As several other of the Convention articles reference instances in which the beneficiary's right to payment is affected, the question arises: can any of these instances not only impede but also end a beneficiary's right to payment?

### **1. Concepts Discussed Elsewhere in the Convention** **a. Transfer and Assignment (Articles 9 and 10)**

Articles 9 and 10 of the Convention cover transfer and assignment of the proceeds, respectively. The Official Comments by the UNCITRAL Secretariat note that the Convention reflects the distinction drawn in practice between transfer and assignment.<sup>37</sup> In practice, a transfer leaves the original beneficiary with no rights, while in an assignment, "the right to demand payment remains with the original beneficiary, the assignee being given only the right to receive the proceeds of payment if such payment occurs."<sup>38</sup> With this distinction made clear, assignment is outside the scope of Article 11(1), as it does not end a beneficiary's right to demand payment, but instead funnels the funds (if paid) to another party (the assignee). Transfers, however, merit closer scrutiny. Under the Convention, the beneficiary's right to demand payment is transferable "only if authorized in the undertaking."<sup>39</sup> The Official Comment adds that the guarantor/issuer also must consent to any transfer.<sup>40</sup>

Some transfers establish substitute beneficiaries and beneficiaries by operation of law.<sup>41</sup> A substitute beneficiary typically appears in standby

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<sup>37</sup> Explanatory Note, *supra* note 7, cmt. 30.

<sup>38</sup> *Id.*

<sup>39</sup> *Id.* art. 9(1); *see also* Explanatory Note, *supra* note 7, cmt. 31.

<sup>40</sup> Explanatory Note, *supra* note 7, cmt. 31.

<sup>41</sup> *See supra* Part II(A); *see also* UNCITRAL, *supra* note 12, ¶ 8; ISP98, *supra* note 3, R. 6.11.

LCs “as a replacement of the original beneficiary when the latter resigns or is removed by the represented beneficiaries, usually the holders of debt or equity securities.”<sup>42</sup> Whether or not such an instance is covered by Article 11(1) depends entirely on the interpretation of “beneficiary” used. If the term refers to each specific beneficiary, then clearly, the removal of one beneficiary by others would end the removed beneficiary’s right to demand payment—something not covered by the Convention’s Article 11(1). However, if a more general definition of “beneficiary” is used, only requiring that one beneficiary remains able to demand payment, this would fit within the scope of Article 11(1), since the remaining beneficiaries (and the substitute) would still remain able to demand payment in such a circumstance, thus not technically would not end the right of “the beneficiary” to demand payment.

A similar problem occurs with beneficiaries by operation of law, which are typically involved in transfers “decreed by statutory, administrative or decisional law in instances where the original beneficiary is insolvent or incapable of acting as a beneficiary.”<sup>43</sup> While statutory transfers are beyond the scope of this note, the concept of an insolvent or incapable beneficiary is one worth a brief investigation. The Convention does not outline the circumstances in which a beneficiary would be unable to act as a beneficiary, but ISP98 mentions several examples, including merger or consolidation, insolvency, death or incapacity, or “that the name of the beneficiary has been changed to that of the claimed successor.”<sup>44</sup>

In such a case, it is possible that the original beneficiary could be unable to function as a beneficiary, and that its right would cease with a required transfer to a second beneficiary. However, this example has another potential problem: cessation of the beneficiary’s right could also occur if the LC is not designated as transferable, as ISP98 notes that “[a] standby is not transferable unless it so states.”<sup>45</sup> As previously mentioned, the Convention reflects a similar opinion: “The beneficiary’s right to demand payment may be transferred only if authorized in the undertaking,

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<sup>42</sup> UNCITRAL, *supra* note 12, ¶ 8.

<sup>43</sup> *Id.* Transferees by operation of law are also mentioned in ISP98 R. 6.11.

<sup>44</sup> ISP98, *supra* note 3, R. 6.12(a)-(d). *See also* U.C.C. §§ 5-102(a)(15), 5-102 cmt.10 (1995).

<sup>45</sup> ISP98, *supra* note 3, R. 6.02(a).

and only to the extent and in the manner authorized in the undertaking.”<sup>46</sup> Thus, if the LC is not specifically subject to transfer by operation of law, then death or dissolution of the beneficiary would end its right to demand payment, as there would be no one to make the required presentation. Thus, in the case of a non-transferable LC, if a beneficiary is unable to act as a beneficiary, there is a cessation to the right to demand payment—an instance that is outside the four provisions of Article 11(1).

### **b. Set-off (Article 18)**

Article 18 of the Convention allows the guarantor/issuer to “discharge the payment obligation under the undertaking by availing itself of a set-off,” unless otherwise stipulated in the undertaking or elsewhere agreed by the parties.<sup>47</sup> The Working Group stated that despite concerns about the effects of allowing set-offs on the liquidity functions of guarantees, at least one English judge had reasoned that precluding such set-offs “would seem very unjust ... and it would seem to me anomalous that such a set-off should be unavailable in letters of credit cases, but available against bills of exchange which are closely analogous.”<sup>48</sup> While the Working Group suggested that set-off was an area of law where “[c]ertainty and uniformity seem to be particularly needed,” it did not provide that clarity.<sup>49</sup> However, for our purposes, the point is moot, as a set-off of the full amount owed would still fall under the scope of Article 11(1)(c), as the amount available under the undertaking would have been paid by the set-off.<sup>50</sup>

### **c. Fraud (Article 19)**

Fraud is a very complicated and involved topic, and, along with the appropriate court measures in response to it (covered in the Convention’s Article 20), was held to be “probably the most important topic for a uniform

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<sup>46</sup> The Convention, *supra* note 1, art. 9(1).

<sup>47</sup> *Id.* art. 18.

<sup>48</sup> UNCITRAL, *supra* note 12, ¶ 84 (citing *The Hong Kong and Shanghai Banking Corp. v. Kloeckner & Co. A.G., Q.B.*, [1989] 2 *Lloyd’s Rep.* 323, 331 (per Hirst J.)).

<sup>49</sup> *Id.* ¶ 89.

<sup>50</sup> The Convention, *supra* note 1, art. 11(1)(c).

law” by the Working Group.<sup>51</sup> In investigating the language used in Article 19, again, our core question will be: can fraud ever be so egregious that the beneficiary’s right to demand payment ceases?

Article 19(1) focuses on exceptions to the guarantor/issuer’s payment obligation, listing instances where “the guarantor/issuer, acting in good faith, has a right, as against the beneficiary, to withhold payment.”<sup>52</sup> Such instances include: clear fraud, demands unsupported by the basis asserted in the demand and supporting documents, and demands with no conceivable basis.<sup>53</sup>

Regarding fraud, one of the Working Group’s earliest concerns in the Convention’s drafting process was that, due to differing procedural law in varying jurisdictions, there existed (and still exists) considerable divergence in “the types and conditions of court measures that may be available in cases of alleged fraud or other objections.”<sup>54</sup> Thus, one of the main purposes of the Convention is “to establish greater uniformity internationally in the manner in which guarantor/issuers and courts respond to allegations of fraud or abuse in demands for payment.”<sup>55</sup> The Convention does not use the term “fraud,” but it does contain exceptions to payment obligations, including a case where it “is manifest and clear that ... [a]ny document is not genuine or has been falsified.”<sup>56</sup> However, the Convention only allows courts to issue provisional orders which temporarily block payments while claims (supported by “immediately available strong evidence”) are investigated, and does not provide courts with any permanent powers to terminate the beneficiary’s claim.<sup>57</sup>

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<sup>51</sup> UNCITRAL, *supra* note 12, ¶ 2.

<sup>52</sup> The Convention, *supra* note 1 art. 19(1)(a)-(c).

<sup>53</sup> Explanatory Note, *supra* note 7, cmt. 9 (stating that the review of the transaction is cursory and only needs to determine whether the documentary demand conforms on its face to the terms. “The guarantor/issuer is not called on to investigate the underlying transaction.”).

<sup>54</sup> The Secretary-General, Report of the Secretary-General on Standby Letters of Credit and Guarantees, ¶ 89, U.N. Doc. A/CN.9/301 (March 21, 1988).

<sup>55</sup> Explanatory Notes, *supra* note 7, cmt. 45.

<sup>56</sup> The Convention, *supra* note 1, art. 19(1)(a).

<sup>57</sup> *Id.* art. 20(1).



ISP98 explicitly avoids the topic of fraud as well as another defense that is theoretically available to the issuer—the lack of authority to issue a standby—stating that “[t]hese matters are left to applicable law.”<sup>58</sup> Section 5-109 of UCC Article 5 is more helpful, noting that if an applicant claims that honoring a presentation of documents would “facilitate a material fraud by the beneficiary,” a court may “temporarily or permanently enjoin the issuer from honoring a presentation or grant similar relief against the issuer or other persons.”<sup>59</sup> However, this potential for permanent relief is undercut by the provision’s requirement that the court must first find that four conditions are satisfied, one of which is “that a beneficiary ... who may be adversely affected is adequately protected against loss that it may suffer because the relief is granted.”<sup>60</sup> Obviously, terminating a beneficiary’s right to collect payment causes that beneficiary to suffer a loss. Thus, it seems highly unlikely that a court would ever find this condition to be satisfied, meaning that no matter how material the fraud, the court is unlikely to ever end a beneficiary’s right to draw under the undertaking.

The Official Commentary on UCC Article 5 indicates how difficult a proposition such fraud would be. First of all, the only exception to the general “no injunction rule” involves fraud “so serious as to make it obviously pointless and unjust to permit the beneficiary to obtain the money.”<sup>61</sup> Secondly, the Official Commentary indicates that, as issuers “may be liable for wrongful dishonor if they are unable to prove forgery or material fraud, presumably most issuers will choose to honor despite applicant’s claims of fraud or forgery unless the applicant procures an injunction”—a difficult task, since “[t]he standard for injunctive relief is high.”<sup>62</sup> While these Notes set a helpful, letter-of-credit-specific standard of material fraud, scholars Gao Xiang and Ross P. Buckley have noted that

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<sup>58</sup> ISP98, *supra* note 3, R. 1.05.

<sup>59</sup> U.C.C. § 5-109(b) (1995).

<sup>60</sup> *Id.* § 5-109(b)(2).

<sup>61</sup> *Id.* § 5-109 cmt. 1.

<sup>62</sup> *Id.* § 5-109 cmts. 2, 4.

generally, U.S. courts have taken “an unduly narrow” approach to material fraud, rarely holding that conduct meets this standard.<sup>63</sup>

However, there are exceptions to this general rule, currently in the form of UCC 5-109, but also in historical case law. For example, in the 1941 United States case *Szteijn v. Henry Schroder Banking Corp.*, the seller shipped worthless rubbish to the buyer, and then demanded payment.<sup>64</sup> The court held that, where the facts of the underlying transaction show that the seller went beyond a mere breach of the agreement to the level of a complete failure to perform, “the principle of the independence of the bank’s obligation under the letter of credit could not be extended to protect the unscrupulous seller.”<sup>65</sup> Thus, where the seller’s misconduct was both intentional and serious, it created an exception to the independence of the undertaking.

Even in England, which has a narrower constriction of fraud than most countries, since it considers LCs to be “the life-blood of international commerce,”<sup>66</sup> the Working Group suggested that there were cases upholding findings of fraud.<sup>67</sup> Thus, in varying jurisdictions, the Working Group found examples of fraud sufficient to justify court action against those beneficiaries.

As for Article 19(1)(c)’s “demands with no conceivable basis,” specific examples are given in Article 19(2), including the following:

- (b) ... The underlying obligation of the principal/applicant has been declared invalid by a court or arbitral tribunal ... ;
- (c) The underlying obligation has undoubtedly been fulfilled to the satisfaction of the beneficiary; ...

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<sup>63</sup> Gao Xiang and Ross Buckley. A Comparative Analysis of the Standard of Fraud Required Under the Fraud Rule in Letter of Credit Law, 13 DUKE J. OF COMP. & INT’L. L. 293, 322 (2003).

<sup>64</sup> UNCITRAL, *supra* note 12, ¶ 11 (citing *Szteijn v. Henry Schroder Banking Corp.*, 31 N.Y.S. 2d 631, 634 (1941)).

<sup>65</sup> *Id.*

<sup>66</sup> *Id.* ¶ 21 (citing *Harbottle v. National Westminster Bank* (per Kerr J.), Q.B., [1977] 2 *All E.R.* 862, 870).

<sup>67</sup> *Id.* ¶¶ 23, 24.

- (e) ... Fulfillment of the underlying obligation has clearly been prevented by willful misconduct of the beneficiary.<sup>68</sup>

In drafting Article 19(2)(b), the Working Group debated whether or not to grant the parties full autonomy to contract around 19(2), but expressed concern over doing so, as allowing such autonomy “would allow the parties to exclude even the most serious cases of improper demand, which could run counter to public order.”<sup>69</sup> The Commission also debated whether or not to draft an additional subsection of 19(2) covering situations where “the amount demanded is manifestly disproportionate to the damage suffered.”<sup>70</sup> This suggestion failed to attract the required support, however, “in particular since that situation was not one of complete lack of a basis for the demand and since it addressed a problem that could be dealt with by including in the guaranty letter a reduction mechanism.”<sup>71</sup> This also explains why gross disparity was not included in Article 11(1).

Article 19(2)(c) essentially restates 11(1)(c)’s statement that “the amount available under the undertaking has been paid” (though from a different source—by the applicant and not the issuer), while 19(2)(d) raises the interesting point that even wilful misconduct on the beneficiary’s part does not end its right to demand payment, but only provides the guarantor/issuer the right to withhold payment in good faith.<sup>72</sup> The right to *withhold* payment is not necessarily indefinite, however, and thus, is not technically a cessation of the beneficiary’s right to demand payment. This limitation is shown in Article 20 of the Convention, which allows a court to issue “a *provisional* order to the effect that the beneficiary does not receive payment” (emphasis added), but is silent on whether or not that court may subsequently issue a final order.<sup>73</sup> As the power to enter a final order is not expressly granted to courts in the Convention, it is unlikely that the

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<sup>68</sup> The Convention, *supra* note 1, art. 19(2) (b)-(d).

<sup>69</sup> UNCITRAL, Working Group on Int’l Trade Practices, Report of the Working Group on International Contract Practices on the Work of Its Twentieth Session, ¶ 27, U.N. Doc. A/CN.9/388 (December 23, 1993).

<sup>70</sup> *Id.* at ¶ 28.

<sup>71</sup> *Id.*

<sup>72</sup> The Convention, *supra* note 1, art. 11(1)(c).

<sup>73</sup> *Id.* art. 20(1)(a).

Working Group intended the Convention to give the power to do so to courts.

## 2. Concepts Not Covered by the Convention

### a. Force Majeure

The 1988 draft of the International Chamber of Commerce (ICC)'s Uniform Rules for Demand Guarantees' Article 14 states that guarantors and confirming guarantors assume no liability or responsibility for consequences arising out of force majeure events, including riots and acts of God.<sup>74</sup> The Convention makes no mention of force majeure clauses, though the Working Group did discuss potentially including a clause stating that guarantors were not liable for the consequences arising from the interruption of business due to "acts of God, riots, civil commotions, insurrections, wars, or any other causes beyond their control or by strikes, lock-outs or industrial action of whatever nature."<sup>75</sup> In its discussions on the topic, the Working Group noted that "guarantee texts often contained force majeure clauses and that even without any contractual exemption a similar result would obtain from the applicable national law,"<sup>76</sup> but that given the divergence in national laws in exempting impediments, it might be beneficial to establish a universal rule "to strive for a greater degree of harmony."<sup>77</sup> Ultimately, however, the Working Group decided not to adopt any of the proposed language on force majeure clauses, as "it was felt that it would not be appropriate to deal with exemption from liability at the statutory level; the issue should be left to the contractual level."<sup>78</sup> Thus, force majeure clauses are outside the scope of the Convention, and depending on the jurisdiction or specific clause contracted for, could possibly end the beneficiary's right to payment under the right circumstances.

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<sup>74</sup> The Secretary-General, *Report of the Secretary-General on Standby Letters of Credit and Guarantees*, Annex, art. 14, U.N. Doc. A/CN.9/301 (Mar. 21, 1988).

<sup>75</sup> UNCITRAL, *supra* note 12, ¶ 65.

<sup>76</sup> *Id.* ¶ 70.

<sup>77</sup> *Id.*

<sup>78</sup> UNCITRAL, Working Group on Int'l Trade Practices, *Report of the Working Group on International Contract Practices on the Work of its Fifteenth Session*, ¶31, U.N. Doc. A/CN.9/345 (June 3, 1991). The specific clause considered by the Working Group is Article 13 of the ICC's Draft Uniform Rules for Demand Guarantees (URDG458), previously cited in UNCITRAL, *supra* note 12, ¶ 65.

### b. Unconscionable Contracts

The Working Group discussed that there may be other objections to payment than fraud: “[a] basic ground for refusing payment would be that the guarantor’s undertaking is void or voidable under the law applicable to questions of material validity.”<sup>79</sup> Depending on the applicable law, examples would include circumstances where “the payment undertaking or its fulfillment would be contrary to public policy, in violation of a legal prohibition, immoral or for similar reasons illegal.”<sup>80</sup> However, despite this discussion, such a provision was explicitly excluded from the Convention: “the Working Group was agreed that the uniform law should not contain any special provisions dealing with instances of invalidity, voidability or unenforceability of payment obligations under guaranty letters.”<sup>81</sup> While the Working Group offered no explicit reason for this decision, presumably, the difficulty of writing an article that would cover a multitude of very different jurisdictions and court systems far outweighed the necessity or utility of such an article. Thus, depending on the jurisdiction, an LC undertaken for illegal reasons, reasons contrary to public policy, or immoral reasons could conceivably end the beneficiary’s right to demand payment. Hence, a beneficiary’s right to demand payment may cease when a court rules or declares that the bank’s obligation has ceased – another instance outside the scope of Article 11(1) of the Convention.

### Conclusion

As stated above, certain types of transfers, egregious cases of fraud, and immoral or illegal letters of credit could all potentially end the beneficiary’s right to demand payment under the undertaking, all of which are outside the scope of Article 11(1) of the Convention. As the Working Group which drafted the Convention discussed all of these matters and left them up to individual contracts and the diverse laws of different jurisdictions, Article 11(1) is not an exclusive list of ways in which the beneficiary’s right to demand payment ceases. However, while Article 11(1) is not an exclusive list, it covers the overwhelming majority of situations in which the beneficiary’s right would cease.

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<sup>79</sup> UNCITRAL, *supra* note 12, ¶ 76.

<sup>80</sup> *Id.* ¶ 77.

<sup>81</sup> UNCITRAL, *supra* note 78, ¶ 80.

## **Contracting out of the United Nations Convention on Independent Guarantees and Standby Letters of Credit**

Ramsey Saleeby\*

### **Introduction**

The purpose of this note is to answer two questions under the United Nations Convention on Independent Guarantees and Standby Letters of Credit (the Convention)<sup>1</sup>: Can parties choose an alternate legal regime? And, which articles, if any, can parties vary? The answers to these questions revolve around two central goals. The first relates to the principle of freedom of contract that underlies letter of credit jurisprudence. Letter of credit law is often justified on the grounds that parties are afforded the freedom to agree on the principles that govern a transaction.<sup>2</sup> Both the applicant and beneficiary agree to shift risk in case of a dispute. The intended shift takes advantage of and assures the independence of letters of credit.<sup>3</sup> Based on this principle, it is not surprising to expect contracting parties to be able to opt out of or modify the rules that apply to their agreement.

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<sup>1</sup> United Nations Convention on Independent Guarantees and Stand-by Letters of Credit, U.N. Doc. A/RES/50/48 (Dec. 11, 1995) [hereinafter *The Convention*].

<sup>2</sup> Revised U.C.C. § 1-302 cmt. 1 (1995) (“freedom of contract is a principle of the Uniform Commercial Code”).

<sup>3</sup> See *Amwest Sur. Ins. Co. v. Concord Bank*, 248 F. Supp. 2d 867, 875 (E.D. Mo. 2003) (“The most fundamental principle of modern letter of credit law is that the three contractual relationships giving rise to the letter of credit are completely independent of each other, and the rights and obligations of the parties to one are not affected by the breach or nonperformance of any of the others.”); *Banco Nacional de Mexico, S.A. v. Societe Generale*, 34 A.D.3d 124, 128 (N.Y. App. Div. 2006) (New York Rev. U.C.C. Article 5) (“[t]he ‘letter of credit’ prong of any commercial transaction concerns the documents themselves and is not dependent on the resolution of disputes or questions of fact concerning the underlying transaction.”); *Grunwald v. Wells Fargo Bank, N.A.*, 725 N.W.2d 324, 328 (Iowa Ct. App. 2005) (“Central to the unique purpose of letters of credit is the ‘independence principle,’ which requires the issuer to pay a beneficiary on proper demand regardless of a breach or default on the underlying contract.”); *New Orleans Brass, L.L.C. v. Whitney Nat’l Bank*, 818 So. 2d 1057, 1060 (La. Ct. App. 2002) (“The independence principle states that the underlying contract . . . between the applicant and the beneficiary, will be viewed as distinct from an overarching contract, i.e. the letter of credit, which is between the applicant's bank and the beneficiary.”).

However, the Convention also sets out to achieve a competing goal. The Convention creates a uniform international standard that “bridges” the disparities between different jurisdictions in their treatment of independent guarantees and letters of credit.<sup>4</sup> Jurisdictions have, otherwise, relied on rules of practice or their own domestic law or applied another jurisdiction’s law. Uniformity is at least a primary goal of the Convention.<sup>5</sup> Allowing parties to contract out of specific articles would certainly weaken uniformity.

The working group addressed these two interests and attempted to create a uniform law that struck a balance between them.<sup>6</sup> Although not expressly stated, the Convention has generally succeeded in this regard. The Convention sufficiently permits parties to contract freely, while preserving its uniform nature through non-variable articles. The American Bar Association (ABA) has provided a list of non-variable Convention articles. The list, however, misses a few mandatory Articles of the Convention.<sup>7</sup>

Part I of this note provides a general framework and context for opting out of the Convention and varying its Articles. Two main sources will be used; the first is the Working Group’s notes and the second is the Uniform Commercial Code (hereinafter “U.C.C.”) Revised Article 5 along with other supplemental materials. Part II of this note discusses how parties may opt out of the Convention. Finally, Part III addresses the variability of Articles in the Convention.

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<sup>4</sup> United Nations Commission on International Trade Law [UNCITRAL], *Report of the Working Group on International Contract Practices on the Work of its Twentieth Session*, ¶ 92, U.N. Doc. A/CN.9/388 (Dec. 23, 1993).

<sup>5</sup> *Id.* ¶¶ 91-92 (showing that the Working Group decided that the Convention should be a Convention in order to preserve uniformity).

<sup>6</sup> *Id.* at ¶¶ 91-2 (the drafting committee discussed the importance of creating a uniform that also retains the fundamental nature of Letters of Credit, party autonomy).

<sup>7</sup> A.B.A., *Report to the House of Delegates on the Adoption of the UN Convention in 1998* ANNUAL SURVEY OF LETTER OF CREDIT LAW AND PRACTICE 278 (James E. Byrne, ed., 1998) (hereinafter A.B.A.).

## I. Framework and Context

### A. Framework

The text of the Convention is silent regarding the variability of its articles; therefore a framework for analyzing variability must be outlined. Two main sources, along with traditional Letter of Credit authority, will be used. The first source will be the working group's notes, letters, and discussions (Notes). The Notes offer insight into the delegates' intent, and reasoning. Examining the Notes will be essential to determine the choice of law mechanism in the Convention and which if any of its articles can be varied.

The second source is Uniform Commercial Code Revised Article 5 (Article 5). The United States is the only nation with a systematic legal regime, adopted by its states, that governs letters of credit.<sup>8</sup> Some nations have a regulatory scheme for dealing with letters of credit, but are not as comprehensive as Article 5.<sup>9</sup> Both the Convention and Article 5 were drafted within a short timeframe of one another. Article 5 is cited in the Notes as an authority on numerous issues pertaining to the drafting of the Convention.<sup>10</sup> Furthermore, the ABA has cited the similarity between the two as a reason for why the United States should adopt the Convention.<sup>11</sup> Article 5 also serves as a framework for the ABA's analysis.<sup>12</sup> In line with the ABA's approach this article will use the Notes to understand the intent

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<sup>8</sup> James E. Byrne, *Contracting Out of Revised UCC Article 5 (Letters of Credit)*, 40 LOY. LA. L. REV. 315 (2006).

<sup>9</sup> UNCITRAL, *Stand-By letters of Credit and Guarantees: Report of the Secretary General*, ¶ 46 U.N. Doc. A/CN.9/301 (Mar. 21, 1988).

<sup>10</sup> See, e.g., YEARBOOK OF THE U.N. COMM. ON INT'L. TRADE LAW, 1990, VOL. XXI, 248; UNCITRAL, *supra* note 9, ¶¶ 47-48 (discussing the importance of U.C.C. prior Article 5 as well).

<sup>11</sup> A.B.A., *supra* note 7, at 286 ("Taken as a whole, the UN Convention is not in conflict with [U.S.] domestic law").

<sup>12</sup> *Id.* at 277 ("U.S. domestic law is based upon Article 5 of the Uniform Commercial Code which has been enacted with some variation in all fifty states. This model statute was revised in 1995 and is in the process of adoption with 16 jurisdictions having adopted it as of February 1, 1997. Because of the speed with which the revision is being adopted and the wide-spread support it has justifiably attracted, this report considers the Convention in light of Revised UCC Article 5 which is likely to be in effect by the time that the UN Convention comes into effect.").



and reasoning of the Working Group, along with the juxtaposition of Article 5.

Finally, variability must be defined. Contracting parties can vary an article of the Convention in two ways; an article can be excluded or altered. An article that is substantially altered is considered excluded.<sup>13</sup>

### B. Context

Throughout the Notes, the delegates debated whether the Convention should be drafted as a convention or a model law.<sup>14</sup> The implications of choosing either one are far reaching. A model law, similar to Article 5, can be adopted piece meal. For example, different states have chosen to adopt Article 5 at different times. Furthermore, some states have adopted non-conforming amendments to the official version of Article 5 or omitted complete subsections. The effect of creating a model law is to provide potential adopters maximum flexibility in what exactly they are adopting.

A Convention is quite the opposite; notwithstanding any reservations, it must be adopted as a whole. Although there was disagreement throughout the Notes, the delegates ultimately chose to draft a Convention. The working group reasoned that a model law would weaken uniformity, which is a fundamental goal of this systematic legal regime. The working group further reasoned that parties could exclude themselves from the Convention entirely or vary some of its articles. The aforementioned balancing interests were therefore achieved.<sup>15</sup> It is important to note the unique questions this choice places before individual states within the United States. This result is unique to the United States because of

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<sup>13</sup> See UNCITRAL, Explanatory note by the UNCITRAL Secretariat on the United Nations Convention on Independent Guarantees and Stand-by Letters of Credit, cmt. 11, U.N. Doc. A/CN.9/431 (July 4, 1996), available at <http://daccess-ods.un.org/TMP/9645256.html> [hereinafter Explanatory Note].

<sup>14</sup> UNCITRAL, *supra* note 4, ¶¶ 91-92.

<sup>15</sup> *Id.* ¶¶ 91-93 (“although less flexible in nature than a model law...a convention regulating international guarantee letters might be incorporated in national legislation through a simplified legislative process”).

federalism, the way commercial law is adopted within the United States and the rights afforded to each individual state.<sup>16</sup>

Finally, different courts may rule differently on the variability of articles of the Convention. A court in one jurisdiction may give effect to altering Article 7(2) of the Convention while another may not. This note attempts to address the practical consequences that parties may face, if they choose to vary a given article of the Convention.

## II. Choice of Law

### A. Choice of Law under Revised U.C.C. Article 5

Article 5 explicitly contains its own choice of law rules.<sup>17</sup> This, at the time, was a relatively novel idea. Prior U.C.C. Article 5 was silent on choice of law and, instead, relied on prior U.C.C. Article 1-105(1). Before widespread adoption of the 1995 revision of Article 5 parties could only choose law that had a reasonable relation to the transaction.<sup>18</sup>

Article 5-116 provides parties complete freedom in choosing any legal regime to apply to their transaction.<sup>19</sup> The requirement that the legal regime have a “reasonable relation” to the transaction has been dropped.<sup>20</sup>

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<sup>16</sup> See generally James White, *Implementing the Standby Letter of Credit Convention with the Law of Wyoming*, 1 Geo. Mason J. Int'l Comm. L. 1 (2010) (discussing potential path to adoption of the Convention for the United States).

<sup>17</sup> U.C.C. § 5-116 (1995) (Choice of Law and Forum).

<sup>18</sup> See prior U.C.C. §1-105(1) (“Except as provided hereafter in this section, when a transaction bears a *reasonable relation* to this state and also to another state or nation the parties may agree that the law either of this state or of such other state or nation shall govern their rights and duties. Failing such an agreement this Act applies to transactions bearing an appropriate relation to this state”) (emphasis added); See e.g., *MSF Holding Ltd. v. Fiduciary Trust Co. Int'l*, 435 F. Supp. 2d 285, 295 (S.D.N.Y. 2006) (choosing New York law as the governing law, which had a reasonable relation to the transaction since the Letter of Credit was issued in New York and the Defendant was physically located in New York); *Trust One Mortgage Corp. v. Invest Am. Mortgage Corp.*, 134 Cal. App.4th 1302, 1308-09 (Cal. Ct. App. 2005) (ruling under California law a choice of law provision is given effect only if the jurisdiction bears a reasonable relationship to the transaction; one of the parties living in the jurisdiction is enough to establish a reasonable relationship).

<sup>19</sup> *Banco Nacional de Mexico, S.A. (BANAMEX) v. Societe Generale*, 34 A.D.3d 124, 130 (N.Y. App. Div. 2006) (New York Rev. Article 5) (stating U.C.C. Revised Article 5-116 no longer requires that the jurisdiction have a reasonable relationship to the transaction. Parties have the freedom to apply any law to their transaction).

Therefore, two contracting parties located in Texas can have the substantive law of North Carolina apply to its transaction.

## **B. Choice of Law under the Convention**

The Convention offers contracting parties similar latitude in choosing a legal regime to apply to their transaction. Articles 1, 21 and 22 of the Convention act as its choice of law mechanism.

### **1. Article 1 (Scope of Application) of the Convention**

Article 1 of the Convention applies to international undertakings “unless the undertaking excludes the application of the Convention.”<sup>21</sup> Therefore, like Article 5-116, contracting parties may choose to have their transaction governed by different law. The instrument or undertaking must explicitly exclude the Convention, and may name a different legal regime. Similar to Article 5-116, Article 1 of the Convention does not require that the governing law have a reasonable relationship to the transaction.<sup>22</sup>

Article 1(3) explicitly removes Articles 21 (Choice of applicable law) and 22 (Determination of applicable law) from its scope. Therefore even if parties choose to apply a legal regime other than the Convention, a court will still use Articles 21 and 22 as the governing choice of law mechanism.<sup>23</sup> The purpose of making Article 1 independent of Articles 21 and 22 is to avoid problems that may arise from *renvoi*. *Renvoi* is a subsection of conflict of law rules that is applied when a forum must apply the law of another jurisdiction.<sup>24</sup> The forum must then decide whether to apply the other jurisdiction’s law as a whole or only the relevant substantive

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<sup>20</sup> *Id.* (“this provision requires applications of . . . substantive letter of credit law when the parties choose it, regardless of any relationship or lack thereof”).

<sup>21</sup> The Convention, *supra* note 1, art. 1(1) (Scope of application).

<sup>22</sup> Explanatory Note, *supra* note 13, cmts. 11, 52-53 (noting the manner in which the Convention might be excluded and other law applied).

<sup>23</sup> *Id.* cmt. 52 (“the Convention contains . . . conflict of law rules to be applied by the courts of Contracting States in order to identify the law applicable to international undertakings as defined in article 2, regardless of whether in any given case the Convention itself would prove to be the applicable law”).

<sup>24</sup> ROBERT A. LEGLAR, AMERICAN CONFLICTS LAW 11-3 (Revised 1968).

portions.<sup>25</sup> Problems arise when a forum looks to another jurisdiction's choice of law rules, which direct the forum to look at its own rules. This back-and-forth reference has been avoided by the Convention by making Articles 21 and 22 applicable to the forum, even if the contracting parties choose to apply a different legal regime under Article 1(1).<sup>26</sup>

There was discussion on the limited practical effects of choosing another legal regime, and therefore the purpose of allowing parties to choose a different legal regime.<sup>27</sup> Some delegates noted how few countries have specific laws on guaranty letters.<sup>28</sup> Therefore, opting out of the Convention, and not choosing another system of law would result in a forum applying either general contract law or may simply apply the Conventions since it would be the only national law.<sup>29</sup> This reasoning, however, is misguided. Most letters of credit are issued by U.S. banks. The U.S. has a systematic legal regime to deal with letters of credit, and each state has adopted Article 5 individually. Arguably, the U.S. alone has fifty different legal regimes (each state is a legal regime). Offering the flexibility to opt out and have the instrument governed by a given state's law may be desirable to the parties.

## 2. Article 21 (Choice of applicable law) of the Convention

Article 21 is straightforward. This article guides the forum as to which law to apply to the transaction. Article 21 makes clear that the forum must apply the law that is specified in the undertaking, or agreed upon elsewhere by the issuer and beneficiary.<sup>30</sup> As previously noted, parties cannot contract out of Articles 21 and 22.

During the drafting process, the working group did not immediately agree on a choice of law provision. There was extensive debate as to the

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<sup>25</sup> *Id.*

<sup>26</sup> *See*, UNCITRAL, *supra* note 4, ¶ 85 (“Inclusion of such rules in the draft Convention would strengthen the reliability and commercial utility of the instruments being covered by recognizing party autonomy in the choice of law and reducing the extent to which disputes would arise as to determination of the applicable law.”).

<sup>27</sup> *Id.* ¶ 105.

<sup>28</sup> *Id.* ¶ 101.

<sup>29</sup> *Id.*

<sup>30</sup> The Convention, *supra* note 1 art. 21 (Choice of applicable law).

practicality of including such a provision. The argument in opposition to including a choice of law provision is twofold. Firstly, if the Convention were drafted as a prototypical convention it would establish a requirement for its own adoption. Secondly, some delegates to the working group argued that a choice of law provision would be useless since conflict of laws questions rarely pose a problem in practice. The working group did eventually agree that a choice of law provision was necessary,<sup>31</sup> and for good reason.<sup>32</sup>

One issue that Article 21 does not address is the degree of formality required by parties to choose another legal regime. The Article's silence on this matter can imply that the Convention seeks to liberally interpret choice of law provisions specified in the undertaking. Therefore, a clause stating that "Chinese national law will apply" may be sufficient as opposed to one stating "This agreement is not subject to the law of [the] Convention, but instead shall be subject to Chinese national law."

More ambiguity exists as to the placement of a valid choice of law clause within an instrument. In other words, where is it acceptable for the issuer and beneficiary to agree on a choice of law, the instrument itself, or some other separate instrument? Article 21(a) gives effect to choice of law provisions "[s]tipulated in the undertaking or demonstrated by the terms and conditions of the undertaking."<sup>33</sup> However, Article 21(b) goes on to give effect to choice of law "[a]greed elsewhere."<sup>34</sup> Therefore, it may be possible that the beneficiary and issuer form a choice of law agreement, outside of the undertaking (which does not mention the choice of law provision). Such a practice could cause confusion in a commercial setting, as it would be unclear from the face of the undertaking that a choice of law agreement exists.

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<sup>31</sup> UNCITRAL, *Report of the Working Group on International Contract Practices on the Work of its Seventeenth Session*, ¶ 139, U.N. Doc. A/CN.9/361 (April 27, 1992).

<sup>32</sup> UNCITRAL, *Report of the Working Group on International Contract Practices on the Work of its Twenty-Second Session*, ¶ 49, U.N. Doc. A/CN.9/405 (November 16, 1994) ("inclusion of such rules in the draft Convention would strengthen reliability and utility of the instrument covered by recognizing party autonomy in the choice of law and by reducing the extent to which disputes would arise in relation to determination of the issue of applicable law. After deliberation, the prevailing view was that the draft Convention should contain provisions on applicable law").

<sup>33</sup> The Convention, *supra* note 1, art. 21(a).

<sup>34</sup> *Id.* art. 21(b).

### III. Varying Articles

The Convention is silent on the issue of variability of its articles. Although silent, the Notes offer insight as to which articles are mandatory and which can be altered or excluded. Article 5 expressly stipulates which of its sections can be varied and can therefore offer insight into the variability of the Convention's articles. The ABA has compiled a list of Convention articles that are mandatory.<sup>35</sup> This list is incomplete and must be supplemented in order to be aligned with international practices regarding independent guarantees and standby letters of credit.

#### A. Variability under Revised Article 5 Section 5-103(c)

Article 5 § 5-103(c) expressly provides which of its provisions are mandatory and deems the rest to be variable. A total of nine provisions of Article 5 are mandatory, Sections: 5-103(a), (c), and (d) (Scope); 5-102(a)(9) and (a)(10) (Definitions); 5-106(d) (Issuance, Amendment, Cancellation, and Duration); 5-114(d) (Assignment of Proceeds); 5-117(d) (Subrogation of Issuer, Applicant, and Nominated Person); and "except to the extent prohibited" in Revised U.C.C. § 1-302.<sup>36</sup>

The main reason for deeming a provision mandatory must be that the provision is essential to the set of rules or body of law. An essential provision, if varied, would alter the fundamental nature of the undertaking. All of the aforementioned non-variable provisions are essential to Revised Article 5.<sup>37</sup> It is important to note that listing Revised Article 5 Section 5-114(d) (Assignment of Proceeds) in Article 5-103(c) does not signify a blanket sanction on its variability.<sup>38</sup> Article 5-114(d) (Assignment of

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<sup>35</sup> A.B.A., *supra* note 7, at 278.

<sup>36</sup> U.C.C. § 5-103(c) (1995) ("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").

<sup>37</sup> A detailed study of U.C.C. § 5-103(c) is beyond the scope of this note. For a comprehensive study on U.S. Revised U.C.C. Article 5 § 5-103(c), *see generally* James E. Byrne, *supra* note 8, at 316.

<sup>38</sup> *See* James E. Byrne, *supra* note 8, at 340-41

Proceeds) can be varied as long as it does not permit an issuer to unreasonably forbid an assignment of proceeds.<sup>39</sup>

## **B. Which Articles of the Convention can be Varied?**

The text of the Convention provides very little guidance, if any, on the subject of the variability of its Articles. The UNCITRAL commentary states clearly that articles can be varied, and that there is significant flexibility allowing such variability.<sup>40</sup> What remains unclear is which articles are mandatory, which ones can be excluded, and which can be altered.

### **1. An Introduction to Convention Variation**

The working group intended that only non-essential articles be variable.<sup>41</sup> One delegate suggested requiring an express statement of party autonomy, such a statement would allow contracting parties to vary any non-mandatory article.<sup>42</sup> Ultimately, the working group did not include an express statement regarding this issue. The Explanatory Note of the Secretariat provides:

Full freedom is given to the parties to exclude completely the coverage of the Convention (article 1), with the result that another law becomes applicable. Since the Convention, if it is applicable, is to a large extent suppletive rather than mandatory, wide breadth is given to exclude or alter the rules of the Convention in any given case.<sup>43</sup>

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<sup>39</sup> *Id.* at 341 (“The statement in Revised U.C.C. section 5-103 that this provision cannot be varied without any qualification, however, is somewhat of an overstatement . . . In effect, this limitation on variance is only a limitation on its exclusion and unreasonable refusal . . .”).

<sup>40</sup> *See* Explanatory Note, *supra* note 12, cmt. 11 (“Since the Convention, if it is applicable, is to a large extent suppletive rather than mandatory, wide breadth is given to exclude or alter the rules of the Convention in any given case”).

<sup>41</sup> UNCITRAL, Secretariat, *Independent Guarantees and Standby Letters of Credit, Discussion of Some Issues of a Uniform Law*, ¶ 74, U.N. Doc. A/CN.9/WG.II/WP.65 (November 13, 1989) (showing that a delegate suggested disallowing variations that would undermine the essential nature of the Convention).

<sup>42</sup> *Id.* ¶ 73.

It is unclear which articles are considered “mandatory” or essential. An article is “mandatory” if excluding or substantially altering it would undermine the fundamental nature of the undertakings governed by the Convention. To maintain uniformity, states adopting the Convention should adhere to this definition of “mandatory.” A state that adopts the Convention and narrows the definition of “mandatory” would give parties too much autonomy to vary articles, thus potentially altering the fundamental nature of the undertaking. In other words, the Convention would then govern undertakings not independent in nature.

## 2. Variation According to the ABA

The subsequent chart lists the articles deemed as non-variable and “mandatory” by the ABA. Each article will be examined to explain its “mandatory” or non-variable status.

<b>Non-Variable Articles of the Convention<sup>44</sup></b>
Article 2 (Scope of application)
Article 7(2) (Formality Requirement)
Article 11(2) (Retention of operative instrument)
Article 14 (Standard of conduct and liability of guarantor/issuer)
Article 19 (Exception to payment obligation)
Article 20 (Provisional Court Measures)

### i. **Articles 1 (Scope of application), 21 (Choice of applicable law), and 22 (Determination of applicable law)**

It is unlikely that Convention Article 1 (Scope of application) can be varied. Undertakings governed by the Convention can be excluded, but undertakings not covered cannot be included. The scope of application of the Convention is a legislative statement of scope, and cannot be contracted without legislative action. Any attempt to do so might give rise to a contractual obligation, which cannot be inferred under the Convention. The only way that Article 1 can be varied is by applying another legal regime. Furthermore, Convention Article 1(3) stipulates that Articles 21 (Choice of applicable law) and 22 (Determination of applicable law) apply to an

<sup>43</sup> Explanatory Note, *supra* note 12, cmt. 11.

<sup>44</sup> A.B.A., *supra* note 7, at 278 (listing the non-variable or “mandatory” articles of the Convention).



undertaking governed by the Convention regardless of whether the contracting parties have opted out of the Convention. Therefore, Articles 21 (Choice of applicable law) and 22 (Determination of applicable law) are also essential to the Convention and cannot be excluded.<sup>45</sup>

## ii. Article 7(2) (Issuance, form and irrevocability of undertaking)

Convention Article 7(2) (Issuance, form and irrevocability of undertaking) provides that 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.”<sup>46</sup> This article is straightforward. An undertaking can be issued in any form, including a non-paper-based-medium, as long as the medium keeps a complete record of the undertaking and is properly authenticated.<sup>47</sup>

Article 7(2) takes a liberal approach to formal requirements. The only requirement is that a complete record of the text be preserved. The Convention is forward-thinking in this regard. Although undertakings and presented documents are usually expected to be in paper form, a shift toward electronic issuance and presentation is underway.<sup>48</sup>

Section 5-104 of Article 5 provides the same function as does Article 7(2), but is not listed in the non-variable provision outlined in Article 5 section 5-103.<sup>49</sup> At first blush classifying Article 7(2) and Article 5 section 5-103 as non-variable is essential. Allowing undertakings that do not preserve a complete record and are not properly authenticated would cause problems for the contracting parties. However, it is important to keep in mind that the fundamental purpose of letters of credit is to shift risk between contracting parties through agreement.<sup>50</sup>

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<sup>45</sup> See *supra* Part II.B.1.

<sup>46</sup> The Convention, *supra* note 1, art. 7

<sup>47</sup> See Explanatory Note, *supra* note 12, cmt. 26.

<sup>48</sup> See e.g., *eUCP Supplement to UCP500 for Electronic Presentation*, International Chamber of Commerce [ICC] Publ'n No. 500/3 (2002).

<sup>49</sup> See U.C.C. § 5-103(c) (1995).

<sup>50</sup> See *supra* note 3.

Convention Article 7(2) prohibits the issuance of oral undertakings. Practically, it would be unthinkable for a guarantor/issuer to orally issue an undertaking because the risks associated with such a practice would be astronomical. This practice would benefit neither of the parties to the undertaking. Therefore, practically speaking, it is of little consequence whether parties are permitted to vary this article and allow oral issuance.

### iii. Article 11(2) (Retention of operative instrument)

Convention Article 11(2) (Cessation of right to demand payment) provides that the beneficiary and issuer may agree that the document embodying the undertaking must be returned to the issuer in order to terminate the beneficiary's right to demand payment prior to expiry or another form of termination.<sup>51</sup> However, Article 11(2) confers no rights onto a beneficiary that retains physical possession of the undertaking after the beneficiary's right to demand payment ceases because the undertaking has expired or the amount of the undertaking has already been paid.<sup>52</sup>

In some jurisdictions, physical retention of the undertaking by the beneficiary prolongs the beneficiary's rights to demand payment.<sup>53</sup> In some cases, regardless of whether the undertaking has expired, the beneficiary can still demand payment as long as he retains physical control. The Convention has rendered this practice ineffective by including Article 11(2) and aligning itself with international standard practice. In this light, the ABA correctly labeled Convention Article 11(2) (Cessation of right to demand payment) as mandatory.

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<sup>51</sup> See The Convention, *supra* note 1, art. 11(2).

<sup>52</sup> *Id.*

<sup>53</sup> See generally Explanatory Note, *supra* note 12, cmt. 34 ("A degree of uncertainty still surrounds, in some jurisdictions, the question of the effect of retention of the instrument embodying the undertaking as regards definitive cessation of the right to demand payment. The Convention, in line with what is regarded widely as the best practice, provides that in no case does retention of the instrument prolong the right to demand payment if the amount available has already been paid or if the undertaking has expired (article 11(2)). Apart from those two contexts, the parties remain free to stipulate a requirement of return of the undertaking in order to terminate the right to demand payment.").

**iv. Article 14(a) (Standard of conduct and liability of guarantor/issuer)**

Convention Article 14 (Standard of conduct and liability of guarantor/issuer) provides that a guarantor/issuer must carry out its obligations with good faith and exercise reasonable care.<sup>54</sup> These standards are to be interpreted with regard to internationally accepted practices.<sup>55</sup> Parties can contract for a lower standard,<sup>56</sup> but the issuer can never be exculpated from liability for failing to act in good faith or exercising reasonable care.<sup>57</sup>

Good faith is not explicitly defined in the Convention or in international practice. However, Article 5 section 5-102(a)(7) defines good faith as “honesty in fact and in the conduct or transaction concerned.”<sup>58</sup> An “honesty in fact” definition of good faith suits the purposes of independent guarantees and standby letters of credit. “Honesty in fact” requires the guarantor/issuer to take facts at face value without further investigation.

A broad definition of good faith is undesirable because the definition should be limited within the context of independent guarantees and standby letters of credit.<sup>59</sup> Such a limitation is warranted in order to preserve the independence principle. For example, in a case where there are allegations of fraud, the guarantor/issuer is not required to investigate the underlying transaction.

Convention Article 14(1) permits contracting parties to define the standard of good faith in accordance with internationally set practice. However, Article 14(2) forbids contracting parties from exculpating the guarantor/issuer from liability for failing to act in good faith and acting with

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<sup>54</sup> See The Convention, *supra* note 1, art. 14(1).

<sup>55</sup> See Explanatory Note, *supra* note 12, cmt. 38.

<sup>56</sup> *Id.*

<sup>57</sup> See Explanatory Note, *supra* note 1, art. 14(2).

<sup>58</sup> U.C.C. § 5-102(a)(7) (1995).

<sup>59</sup> James G. Barnes, *Defining Good Faith Letter of Credit Practices*, 28 LOY. L.A. L. REV. 101, 109 (1994) (arguing that an expansion of the definition of good faith beyond the “honesty in fact” standard would contradict the substantive decision that compliance should be strict instead of reasonable).

gross negligence.<sup>60</sup> In other words, Article 14 sets a minimum standard of conduct rather than *the* standard of conduct. From a public policy standpoint, excluding Article 14(2) would be considered unconscionable. Very few courts would allow contracting parties to release the guarantor/issuer from liability for acting with gross negligence.

The ABA, therefore, was correct in determining that Convention Article 14 cannot be excluded. However, even though Article 14 cannot be excluded, parties can still agree to set the level of standard of conduct. Courts would allow contracting parties to alter the standard of conduct outlined in Article 14.

Reasonable care does not have much bearing on undertakings. It is usually cited out of habit and has no true definition or function. There is no real definition of reasonable care in international practice or in Article 5. For example, the preclusion rule is practiced on the international level, but is at times considered unreasonable.

**v. Article 19 (Exception to payment obligation) and Article 20  
(Provisional court measures)**

The Convention was drafted to “bridge” the differences between different jurisdictions. A “bridge” was most needed in the area referred to by common law countries as the fraud exception to the independence principle. The treatment of fraud is unique in this regard because of the disparity in its treatment between jurisdictions.<sup>61</sup> Convention Article 19 (Exception to payment obligation) was drafted to deal with the issues arising out of this disparity by offering a uniform treatment of fraud.

Article 19 provides the issuer with an exception to its obligation to honor a beneficiary’s presentation.<sup>62</sup> Although the words “fraud” and “abuse” are not used, there is a clear standard regarding the exception to

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<sup>60</sup> The Convention, *supra* note 1, art. 14.

<sup>61</sup> See JAMES E. BYRNE, HAWKLAND UNIFORM COMMERCIAL CODE SERIES, VOLUME 6B, [REV.] ARTICLE 5 LETTERS OF CREDIT, 5-109:7 (West Group Pub. 2008) (Discussing that what common law countries call “fraud” is referred to as an “abusive drawing” in civil code countries. Abusive drawings are very closely dependent on notions of good faith.). An example of an abusive drawing would be where a beneficiary coerces the applicant into default and then draws on the letter of credit.

<sup>62</sup> See The Convention, *supra* note 1, art. 19.

payment obligation. The standard is compatible with Article 5 section 5-109 and would perpetuate the high standard of showing<sup>63</sup> required to prove letter of credit fraud set by cases such as *Sztejn v. J. Henry Schroder Banking Corporation*.<sup>64</sup>

The ABA deemed Articles 19 (Exception to payment obligation) and 20 (Provisional court measure) to be non-variable, even though Article 5 section 5-109 is variable.<sup>65</sup> Varying Convention Articles 19 and 20 has the potential of expanding or narrowing the exception to the independence principle. Awarding injunctive relief too liberally would undermine the independence principle. It would disturb the aforementioned agreement to shift the risk between the applicant and the beneficiary, thereby undermining letter of credit practice as a whole. The beneficiary would feel less and less secure with using letters of credit if injunctions could be easily obtained. On the other hand, if it is too difficult for an applicant to receive injunctive relief based on a claim of fraud or forgery, concerns regarding equity would arise. This would again undermine letter of credit practice.

Since such a delicate balance is required, the ABA is correct in deeming Articles 19 (Exception to payment obligation) and 20 (Provisional court measure) as mandatory. These two Articles should not be permitted to be excluded or substantially altered.

A court has three options if the contracting parties decided to vary the Convention Articles 19 (Exception to payment obligation) and 20 (Provisional court measure). The first would be to simply refuse to enforce it as contrary to public policy and letter of credit law.<sup>66</sup> The second would be to revert to reasoning outlined in *Sztejn*.<sup>67</sup> Therefore, as a practical matter varying Articles 19 (Exception to payment obligation) and 20 (Provisional court measure) would have little to no affect on letter of credit standard

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<sup>63</sup> UNCITRAL, Report of the Working Group on International Contract Practices on the Work of its Twenty-Third Session, ¶ 120, UN Doc. A/CN.9/408 (Feb. 15 1995).

<sup>64</sup> 31 N.Y.S.2d 631 (N.Y. Sup. Ct. 1941).

<sup>65</sup> See U.C.C. § 5-103(c) (1995) (U.C.C. § 5-109 is not included in the list of non-variable sections in §5-103(c). Therefore, the drafters of U.C.C. Revised Article 5 intended that § 5-109 be variable).

<sup>66</sup> James E. Byrne, *supra* note 8, at 360.

<sup>67</sup> *Id.* (citing *Sztejn v. J. Henry Schroder Banking Corp.*, 31 N.Y.S.2d 631 (Sup. Ct. 1941)).

practice. Finally, a court may simply treat the undertaking as a traditional contract instead of an independent undertaking.<sup>68</sup>

Although Articles 19 (Exception to payment obligation) and 20 (Provisional court measure) are mandatory and cannot be substantially altered, courts should and will likely permit some alteration. For example, Convention Article 19 (Exception to payment obligation) does not provide a list of protected parties. Contracting parties may wish to align themselves with Article 5 section 5-109, which does have a list of protected parties, and protects a confirmer who has honored in good faith. Furthermore, contracting parties may alter Article 19 (Exception to payment obligation) and agree on a different form of relief, such as arbitration, where there is letter of credit fraud. Finally, contracting parties should be allowed to agree that minute lies are permissible and do not constitute letter of credit fraud. Therefore, while Articles 19 (Exception to payment obligation) and 20 (Provisional court measure) may not be excluded, they can be altered.

### 3. What is missing?

The ABA's understanding of the variability of articles in the Convention is incomplete. If their list of non-variable articles is endorsed, parties will be permitted to vary articles that are essential to the Convention.

<b>Essential Articles Not Included in ABA's List of Non-Variable Articles</b>
Article 1 (Scope)
Article 3 (Independence of undertaking)
Article 6(b) (Definitions)
Article 2 (Undertaking)
Article 12(c) (Expiry)
Article 14(a) (Good faith and Reasonableness)

#### **i. Article 3 (Independence of undertaking)**

Convention Article 3 (Independence of undertaking) outlines the independence principle as it applies to independent guarantees and standby letters of credit. Convention Article 3 is mandatory and cannot be excluded or altered. The independence principle is the fundamental characteristic of

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<sup>68</sup> *Id.* at 360-61.

guarantees and standby letters of credit altering it would render the undertaking a contract.

### **ii. Article 12(c) (Expiry)**

Convention Article 12(c) (Expiry) provides that if an undertaking does not stipulate an expiration date and holds itself to be perpetual, the undertaking will expire six years after it is issued.

Contracting parties would have to exclude Convention Article 12(c) (Expiry) in order to agree that their undertaking is perpetual. Different courts may rule differently on this matter. However, courts should maintain a commercially sound rule and not give effect to such a variation. Independent undertakings are inherently finite and courts should align themselves with this notion.<sup>69</sup>

### **iii. Worthy of Note: Article 10 (Assignment of Proceeds), Definitions, and obligations.**

Although its parallel provision in Article 5 is designated as non-variable in Article 5 section 5-103(c),<sup>70</sup> Convention Article 10 (Assignment of Proceeds) needs to be variable.<sup>71</sup> Despite its designation as non-variable, assignment of proceeds can actually be altered under Article 5<sup>72</sup> and should be permitted in the Convention.

The definition of an undertaking in Convention Article 2 (Undertaking) and the definitions in Article 6 (Definitions) do not have to be mandatory. Contracting parties can alter these definitions and still have their undertaking appropriately governed by the Convention. Finally, the obligations of the guarantor/issuer can also be altered by agreement. These practices are in accordance with internationally accepted rules and laws.

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<sup>69</sup> Explanatory Note, *supra* note 12, cmt. 35.

<sup>70</sup> U.C.C. § 5-103(c) (1995) (stating that §5-114(d) concerning assignment of proceeds cannot be varied).

<sup>71</sup> *See supra* Part III.A.

<sup>72</sup> James E. Byrne, *supra* note 8, at 340-41 (“[I]n effect, this limitation on variance is only a limitation on its exclusion and unreasonable refusal ...”).

### **Conclusion**

The Convention provides a clear mechanism for contracting parties to opt out of the Convention and choose some other legal regime to govern their agreement. Convention Articles 1 (Scope of application), 21 (Choice of applicable law), and 22 (Determination of applicable law) give contracting parties a great deal of latitude in choosing opting out of the Convention. However, if any litigation does occur Article 1(3) applies, even if another legal regime governs the undertaking.

The variability of Articles under the Convention is slightly more complex. The text and Notes are generally silent on which Articles are mandatory and essential to the Convention. The ABA has provided a list of Convention Articles that it deems to be non-variable. This list is incomplete. A more functional approach to the variability of articles would be to mimic Article 4 section 5-103(c) where appropriate. Such an approach entails making Convention Article 3 (Independence of undertaking) and Article 12(c) (Expiry) mandatory, without the possibility of alteration. Assignment of proceeds, and the definitions need not be mandatory under the Convention and can be altered or excluded.