

Master of Laws Dissertation

**INDEPENDENT BANK GUARANTEES AS PROTECTION
AGAINST
BREACH OF CONTRACT IN INTERNATIONAL TRADE**

by Ulf Schelenz

School for Advanced Legal Studies

University of Cape Town

Student number: SCHULF002

Supervisor: Prof. John Hare

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To my family, especially to my parents who have always made the impossible possible for their children and who have considerably influenced my path

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CHAPTER 1 - INTRODUCTION

Independent bank guarantees are commonly used in international trade as protective means in order to ensure that the underlying obligation is properly fulfilled. These guarantees take a number of different forms and are often interlinked in one and the same major international transaction. It is essential for the participants to know about the operation of bank guarantees and to be aware of the risks involved.

Frequently the parties' attention is taken up with negotiation of the substantive contract and insufficient time is allocated for consideration of the text of the guarantee. As an international businessman of a major company and former European counsel to Citibank emphasizes, 'there is a widespread but erroneous belief that employers never call these guarantees'.¹ Accordingly, insufficient effort is made to negotiate them and useful protective measures are not incorporated.

This thesis aims at introducing the various types of bank guarantees that are most often used in international business practice and deals with the operation of these guarantees. Subsequently, potential problems in the context of guarantees and ways to manage these situations will be pointed out. In particular, one section focuses on the viewpoint of the bank's customer and the significant problem of unfair calling.

In addition, it is important to examine the law and rules of bank guarantees because they govern these popular instruments.

Another goal of this thesis is to consider the current trends in international trade and its business practice. National aspects and only theoretical disputes in legal writing, therefore, will be cut to a minimum, but will not be excluded completely.

In order to realize the discussion on such a broad topic as bank guarantees in international trade, certain important issues have to be left outside the scope of this thesis. For example, conservatory attachments and Mareva injunctions as procedural countermeasures against abuse are mostly not covered. Neither does this thesis focus on accessory guarantees.

¹ Jonathan D. Lass in: Rowe, Guarantees, p. 91.

CHAPTER 2 – OVERVIEW

A. General remarks

I. Significance of independent bank guarantees

Independent bank guarantees are a relatively new legal phenomenon. They appeared in the American domestic market in the 1960s and were noticed in banking practice in the beginning of the 1970s.² Since this time the influence of bank guarantees/bonds³ in international trade increased steadily. Bank guarantees attracted greater attention because single contract amounts and associated bonding requirements increased tremendously in the period of 1975 until 1985. This was caused by the emergence of gigantic hydroelectric projects (especially in Latin America) and large infrastructure projects in the middle East and Africa.⁴ In general, the increasing wealth in the oil producing countries of the Middle East enabled these countries to conclude major contracts that included large sums of money for industrial and agricultural projects or national defence.⁵ To secure the fulfilment of the respective obligations, bank guarantees were utilized. Furthermore, banks have increasingly replaced the role of surety companies in respect to international construction contracts.⁶ The reason is that foreign employers or purchasers feel more comfortable with a commitment from a financial institution that is established locally or whose worldwide reputation and credit standing is widely known.

In international trade nowadays, Bertrams correctly emphasizes ‘one may safely assume that major transactions (...) do not take off without some kind of guarantee support’.⁷

² Note, ‘Recent extensions in the use of commercial letters of credit’, 66 Yale Law Journal 1957, 902 at 902; Goode, Commercial Law, p. 695.

³ Rowe, Guarantees, p. 82. The term ‘bond’ has no defined meaning in law-see: Bertrams, Bank Guarantees in International Trade, p. 4; In this thesis, it is utilized synonymous with guarantee.

⁴ Gmuer, Trade Financing, p. 185.

⁵ Kronfold, ‘The Syndication of Risk in Unconditional Bonds’, Journal of Business Law 1984, 13 at 13; Bertrams, Bank Guarantees in International Trade, p. 1.

⁶ Gmuer, Trade Financing, p. 185.

⁷ Bertrams, Bank Guarantees in International Trade, p. 1.

To reinforce the mentioned developments, it is useful to present some figures: The total of the outstanding contingent liabilities of banks in the United States in 1981 amounted to \$ 49 billion and increased to \$ 105 billion in 1985.⁸ According to an estimate of the Drafting Committee of the revised Article 5 of the US Uniform Commercial Code this amount has further increased to \$ 250 billion in 1995, and \$ 500 billion worldwide.⁹

II. Functions of independent bank guarantees

Bank guarantees in international trade have in general two fundamental functions: A preventive and a remedial function.

The so-called preventive purpose confers the beneficiary an additional, tangible assurance that the commercial contract will yield the expected results.¹⁰ The rationale for such a conclusion is that a bank will only issue a guarantee if it has diligently assessed the account party's financial standing, its trade reputation and its ability to perform successfully under the contract terms. Therefore, besides its own evaluation the beneficiary receives a second assessment of the account party's economic soundness if a bond is issued.

The second purpose of a bank guarantee is to give access to additional resources in the event that the risk covered by the bond is realized. For example in case of non-performance, the beneficiary is justified to call a performance bond. Hence, the guarantee's purpose is to limit the adverse consequences of incompetence, default or dishonesty, thanks to the availability of additional financial resources. This can be referred to as the remedial function of the guarantee.

B. Characteristics and terminology

I. Independent bank guarantees

⁸ Rowe, *Guarantees*, p. 111.

⁹ Bertrams, *Bank Guarantees in International Trade*, p. 1, footnote 2.

¹⁰ Gmuer, *Trade Financing*, p. 187.

The modern independent bank guarantee is a device that was developed by practice and the concept, as it functions today, was unknown in law.¹¹ Bank guarantees have to be distinguished from the traditional letter of credit as method of payment. A letter of credit is a document of a bank containing the promise to the seller to pay a certain sum of money against certain documents furnished by the seller.¹² In contrast to primary payment instruments,¹³ a bank guarantee is utilized in a situation in which the account party **fails** to perform an obligation undertaken by him towards the beneficiary.¹⁴

There are some other traditional devices which secure the beneficiary against the risk of non-performance, namely accessory guarantees¹⁵ which are known as suretyships. A surety takes on the debt of the principal debtor, while an independent guarantor who pays the beneficiary settles its own debt.¹⁶ Concomitantly, suretyships are disadvantageous to the creditor because the accessory guarantor can invoke every defence that the principal could raise.¹⁷ This generates the consequence that the creditor has often to institute legal proceedings in order to pursue its claim. Such an undertaking is connected with inconvenience and the considerable risk of a defeat in a litigation. On the other hand, banks incline to be reluctant in issuing accessory guarantees because they do not know in what circumstances they should proceed to payment and, by examining the situation, they run the risk to become involved in the underlying contract.¹⁸ To avoid the mentioned effects,¹⁸ practice has developed independent guarantees, issued by reliable and financially sound institutions such as banks.

It is noteworthy that the area of international guarantees is terminologically marked by confusion, uncertainty and inconsistency owing to different national and international use of terms both in banking and non-banking sectors.¹⁹ In this thesis, the term

¹¹ Bertrams, *Bank Guarantees in International Trade*, p. 3.

¹² Schiller, 'Law in Practice: Risk Exposure in International Sales', *Materials to the course 'The Law of International Trade'*, VI:3.

¹³ In respect to methods of payment in general: Juutinen, 'Methods of Payment and Exporter's risk exposure', LLM-Dissertation, 1999, p. 1 et seq.

¹⁴ Juutinen, 'Methods of Payment and Exporter's risk exposure', LLM-Dissertation, 1999, p. 7, 9.

¹⁵ In the United States and the United Kingdom the term 'guarantee' is generally taken to denote the accessory type of guarantee. In this thesis, the term 'guarantee' means independent guarantee.

¹⁶ Von Houtte, *The Law of International Trade*, p. 301.

¹⁷ Bertrams, *Bank Guarantees in International Trade*, p. 2.

¹⁸ Goode, 'Surety and On-Demand Performance Bonds', *Journal of Business Law* 1988, 87 at 88.

¹⁹ Rowe, *Guarantees*, p. 42.

'independent' guarantee is utilized in contrast to 'accessory' or 'conditional' guarantees. According to American legal language, an independent guarantee is described as primary obligation as opposed to the secondary obligation of the surety.²⁰ In order to describe the guarantor's obligation, other terms are frequently used as 'autonomous', 'abstract' and 'unconditional guarantees' or 'indemnities'.²¹ Whatever wording is utilized, it serves the same purpose, namely to point out that payment is to be made if and only if the conditions of payment as stated in the **guarantee** have been fulfilled. Accordingly, if the terms and conditions of the guarantee are met, the bank must pay and it cannot invoke defences derived from the underlying contract.²²

II. Conditional and unconditional bank guarantees

Independent guarantees can occur in both conditional and unconditional forms. Conditional bonds, as opposed to unconditional bonds, are dependent on the existence of breach of contract by the account party. A conditional bond is an ancillary obligation which, to be callable, needs **proof** of breach of contract, instead of a simple declaration of default by the beneficiary.²³ An unconditional bank guarantee, on the other hand, is a separate legal obligation whereby the issuer commits himself to pay a sum of money without further examination of the true respect or breach of terms under another contract.²⁴ If the unconditional bond is given in a first demand form the obligation to make payment arises on the first (written) request of the beneficiary including the mere **statement** of the account party's default. Such first demand bonds have attracted the greatest attention and are the prevailing type of independent guarantees in international trade today.²⁵ The reason for this development is that autonomous guarantees enable banks to stand clear of any contractual dispute which may arise between the parties to

²⁰ Horn/Wymeersch, *The Law of International Trade Finance*, p. 460; Rubino-Sammartano, 'Performance Bonds: Primary or Secondary Obligations?', *International Business Lawyer* 03/1985, 125 at 126.

²¹ Von Houtte, *The Law of International Trade*, p. 300; Bradgate/White, *Commercial Law*, p. 286; Penn/Shea/Arora, *The Law relating to Domestic Banking*, p. 318.

²² Bannier, 'Bank Guarantees and Documentary Credit', *Hague-Zagreb Essays* 6 1987, 65 at 68; Von Houtte, *The Law of International Trade*, p. 300.

²³ Penn/Shea/Arora, *The Law and Practice of International Banking*, p. 268.

²⁴ Gmuer, *Trade Financing*, p. 189.

²⁵ Bertrams, *Bank Guarantees in International Trade*, p. 1.

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²⁰ Horn/Wymeersch, *The Law of International Trade Finance*, p. 460; Rubino-Sammartano, 'Performance Bonds: Primary or Secondary Obligations?', *International Business Lawyer* 03/1985, 125 at 126.

²¹ Von Houtte, *The Law of International Trade*, p. 300; Bradgate/White, *Commercial Law*, p. 286; Penn/Shea/Arora, *The Law relating to Domestic Banking*, p. 318.

²² Bannier, 'Bank Guarantees and Documentary Credit', *Hague-Zagreb Essays* 6 1987, 65 at 68; Von Houtte, *The Law of International Trade*, p. 300.

²³ Penn/Shea/Arora, *The Law and Practice of International Banking*, p. 268.

²⁴ Gmuer, *Trade Financing*, p. 189.

²⁵ Bertrams, *Bank Guarantees in International Trade*, p. 1.

the underlying contract.²⁶ Conversely, this type of guarantee is known to many bankers as the 'suicide form' of the account party.²⁷

First demand guarantees are common in certain trade branches, regions and in certain circumstances, but its growth is primarily occasioned by the fact that international trade tends to take place in a buyer's market. Where the bargaining power of the seller is stronger, it might be able to negotiate for a conditioned guarantee which is payable only if the buyer produces third party documents attesting breach of contract or even a judicial or arbitral award affirming the buyer's right to payment.

From the bank's point of view, it is necessary to ensure that all parties are bound by the documentary evidence. In other words, the finding of the third party must be conclusive and not subject to appeal so that the bank knows by examining the submitted documents if the payment mechanism is finally triggered or not.

III. Operation of direct and indirect bank guarantees

1. Involvement of several parties

In order to understand potential problems which may arise in the context of guarantees, it is necessary to be aware of the participants in a bank guarantee. The structure of a bank guarantee encompasses at least three different parties.²⁸

The guarantee itself is a bilateral contract between the guarantor/bank and the beneficiary. This contract is independent from the underlying contract between the principal debtor (account party) and creditor (beneficiary). The third relationship is the one between the principal debtor (account party or bank's customer) and the bank.

Although distinct, these three relationships are intrinsically linked to one and another and they affect each other. Often, there are some more parties involved, especially in an indirect guarantee.

²⁶ Schmitthoff, *Schmitthoff's Export Trade: The Law and Practice of International Trade*, p. 448.

²⁷ Penn/Shea/Arora, *The Law and Practice of International Banking*, p. 268.

²⁸ Dobson, *Charles Worth's Business Law*, p. 559.

2. Direct guarantee

A direct guarantee is based on an underlying contract which stipulates the issuance of a bank guarantee in order to secure proper performance of obligations. The principal debtor, who has to provide the guarantee in favour of the creditor, instructs its bank to issue the guarantee with terms and conditions as specified by him. The bank usually issues the demanded guarantee and charges a fee for it. Should the bank be called on to effect payment in accordance with the terms and conditions of the guarantee, the principal debtor/account party is then obliged to reimburse the bank. The possibility to take recourse is usually based on a counter-guarantee that is incorporated in a contract of mandate between the bank and its customer.²⁹

The issuance of the bank's guarantee is determined by the account party's instructions. These specify the circumstances in which the bank's payment shall be triggered. The account party's instructions, in turn, are in accordance with the conditions of payment fixed by the contract between the principal debtor and the creditor. The bank's influence in respect to the payment conditions is rather little.

It is common in situations in which the beneficiary is situated abroad to have the participation of an advising bank in the beneficiary's country. The role of the advising bank is confined to the notification and transmission of the guarantee as well as the transmission of communications from the beneficiary to the account party's bank. In contrast to a letter of credit, the advising bank does not usually function as paying bank. Furthermore, it does not assume any obligations towards the beneficiary as far as the guarantee is concerned, but it may owe a general duty of care towards the beneficiary.³⁰ This general duty encompasses, for instance, the checking of the authenticity of the guarantee, so that obvious forgery is revealed.³¹ However, the main purpose for the participation of the advising bank is to transmit information in order to facilitate the implementation of international bonding practice.

²⁹ Bertrams, *Bank Guarantees in International Trade*, p. 13; Bannier, 'Bank Guarantees and Documentary Credit', *Hague-Zagreb Essays* 6 1987, 65 at 73.

³⁰ Bertrams, *Bank Guarantees in International Trade*, p. 14.

³¹ See for example: *Trib. Com. Antwerp*, September 25 1987, *Tijdschrift Belgisch Handelsrecht* 1989, p. 100.

3. Indirect guarantee

It is not uncommon that guarantees are issued by banks in the beneficiary's country abroad. If the underlying agreement stipulates such an undertaking the account party requests its bank to instruct a bank in the beneficiary's country to issue the guarantee. The bank which instructs the other bank is mostly³² called the instructing or first bank, while the instructed bank is named the issuing, correspondent or second bank.³³

It must be pointed out that there is no direct, contractual relationship between the account party and the issuing bank abroad.³⁴ Conversely, it does not exist any contractual relationship between the beneficiary and the instructing bank. It is only the second bank which issues the guarantee and that will render payments towards the beneficiary. Similar to direct guarantees, the instructing bank has to indemnify the issuing bank pursuant to a counter-guarantee³⁵ if the payment mechanism is properly triggered by the beneficiary. The instructing bank, in turn, takes recourse against its account party in the same way as pursuant to a direct guarantee.

The issuance of a guarantee by a bank in the beneficiary's country is advantageous to the beneficiary because its local law and practice will be normally applicable on the guarantee. In addition, the issuing bank could be the beneficiary's house bank or otherwise, it is easier for the beneficiary to examine the financial soundness of the issuing bank. The beneficiary is in a better position if the issuing bank is in its home country because the issuing bank will usually be inclined to pay more attention to the beneficiary's interests than to those of an account party situated in a foreign country and with whom it has no contractual relationship. Furthermore, the beneficiary can contact the second bank in respect to any inquiries more easily than it would be possible in circumstances with a bank abroad.

³² Exception in France where the terms first and second bank are exchanged because the beneficiary's point of view is regarded as crucial.

³³ Horn/Wymeersch, *The Law of International Trade Finance*, p. 466; Penn/Shea/Arora, *The Law and Practice of International Banking*, p. 274.

³⁴ Horn/Wymeersch, *The Law of International Trade Finance*, p. 466.

From the point of view of the account party, indirect guarantees are disadvantageous and are, therefore, not advisable. The first bank's counter-guarantee in favour of the second bank is often not as narrow or restrictive as the primary issued guarantee in favour of the beneficiary.³⁶ Therefore, the account party's risk exposure to render payment to the first bank is higher than in a direct guarantee. Furthermore, the account party is obliged to pay bank charges to both the first and second bank for the issuance of the counter-guarantee and the bank guarantee.

IV. Standby letters of credit

Standby letters of credit are commonly used in the United States in place of bank guarantees. The rationale for this development is that banks in the United States are not empowered to issue guarantees in general.³⁷ Historically, this was considered to be widely the business of surety companies and banks would act *ultra vires* by issuing guarantees.³⁸ However, this view was limited by American law³⁹ which acknowledged the power of banks to act as guarantors in so far as the instrument is couched in the form and technique of a letter of credit and the 'bank must not to be called upon to determine questions of fact or law at issue between the account party and the beneficiary'.⁴⁰ Accordingly, banks introduced the term standby letter of credit⁴¹ in order to emphasize that the instrument is, on one hand, a security device in contrast to the traditional letter of credit as payment method but, on the other hand, is akin to the commercial letter of credit because of its independence to the underlying contract.

³⁵ Rubino-Sammartano, 'Performance Bonds: Primary or Secondary Obligations?', *International Business Lawyer* 03/1985, 125 at 125. According to German and American legal language, this counter-guarantee is often called indirect guarantee.

³⁶ Bertrams, *Bank Guarantees in International Trade*, p. 65.

³⁷ See the National Bank Act of June 3, 1864 (at present 12 U.S.C. Sec. 24 (1988)) that sets out the activities in which banks are authorised to engage.

³⁸ Harfield, *Bank Credits and Acceptances*, p. 154; Kronfold, 'The Syndication of Risk in Unconditional Bonds', *Journal of Business Law* 1984, 13 at 13 and footnote 3.

³⁹ Interpretative Ruling by the Comptroller of the Currency of May 1977, 42 Fed. Reg. 24, 206 (1977).

⁴⁰ Bertrams, *Bank Guarantees in International Trade*, p. 5.

⁴¹ The term has to be distinguished from standby credit and standby line of credit which describe a totally different kind of financial instrument. See: Rowe, *Guarantees*, p. 109.

Hence, the expression standby letter of credit originated from practice and is not a precise legally defined term.⁴²

Today, the terms 'standby letters of credit' and 'independent bank guarantees' are used interchangeably in American and international business practice.⁴³ This undertaking is appropriate in light of the same function of both financial instruments, that is the furnishing of security, and the same significant features as the principle of independence and the documentary nature of the conditions of payment. The differences are rather slight and refer primarily to practice and terminology. Therefore, this thesis includes standby letters of credit by using the term independent guarantees.

V. Syndicated guarantees

The described current trends to large-size bonds and first demand guarantees have generated an increasing number of syndicated bonds during the last years.⁴⁴ Individual banks have been unwilling to take a huge risk exposure all on its own and have resorted to the syndication technique, thereby spreading the bonding risk. The usual technique, which is ordinarily preferred by the beneficiary, is that one bank - the so-called leading bank - issues the guarantee for the full amount and this is backed up by counter-guarantees from the participating banks. Upon payment the leading bank usually takes recourse against the syndicate banks. The single participating bank will severally reimburse the issuer for any loss it may suffer under the bond. The obligation of each participant will normally be *pro rata* its commitment under the syndicate facility.⁴⁵ The participating banks, in turn, are indemnified by the account party as principal debtor.

Besides the clear advantage for banks in sharing the bonding risk, there are other benefits that occur by the syndication of bonds:

For other bonding institutions, the existence of a properly structured and well-managed syndication is sometimes the prerequisite for a support of the account party with additional bonding arrangements. Furthermore, syndicated guarantees confer the benefit

⁴² Rowe, *Guarantees*, p. 109.

⁴³ Horn/Wymeersch, *The Law of International Trade Finance*, p. 460.

⁴⁴ Kronfold, 'The Syndication of Risk in Unconditional Bonds', *Journal of Business Law* 1984, 13 at 13.

for the account party that its name is publicised to a wide range of (national and international) financial institutions.⁴⁶ This might be useful for subsequent financial undertakings.

On the other hand, there are some disadvantages of syndicated bonds as well: The documentation procedure is more complicated because there are several parties involved and this consumes more time. From the account party's point of view, a syndication generates an increase of costs because additional fees are required to compensate the undertaking of the leading bank and the syndicate banks.⁴⁷

C. Most common types of bank guarantees

Bank guarantees are flexible instruments and, therefore, can be utilized to cover all kinds of risks. Accordingly, it exists a variety of different types of bonds. Depending on the respective area of international trade and the involved risks of a single contract, the range extends from customs bonds to crude oil lifting bonds.⁴⁸ Bearing in mind the existence of the wide range of bonds, the scope of this thesis is limited to the most frequently used guarantees in international trade today. However, all bonds basically serve the same overall purpose, namely as protection against breach of contract.

Bank guarantees can be distinguished in two main categories: Guarantees that secure financial obligations and guarantees that provide security for non-financial obligations. The former group, for instance, encompasses the security of the **financial** obligation of the buyer in respect of the payment of the purchase price. The second category includes, for example, the security of the seller's **non-financial** obligation for the delivery of the goods.

It is important to notice that the label of a bank guarantee does not necessarily correspond with the risk which is covered by the guarantee. In addition, it must be

⁴⁵ Penn/Shea/Arora, *The Law and Practice of International Banking*, p. 283.

⁴⁶ Kronfold, 'The Syndication of Risk in Unconditional Bonds', *Journal of Business Law* 1984, 13 at 20.

⁴⁷ Kronfold, 'The Syndication of Risk in Unconditional Bonds', *Journal of Business Law* 1984, 13 at 20.

⁴⁸ See for details for example: Rowe, *Guarantees*, p. 78 and Gmuer, *Trade Financing*, p. 201 et seq.

pointed out that some types of guarantees can be used for more than one purpose.⁴⁹ For instance, a performance guarantee usually covers the risk of defects during the maintenance phase after delivery of the goods⁵⁰ or a repayment guarantee might also be used for the same purpose as a performance guarantee. Hence, the label of a guarantee is not crucial. It is rather that the ambit and purpose must be deduced from the actual risks which are covered by the guarantee. This undertaking requires reference to the textual risk description, an evaluation of the terms and conditions of the guarantee, especially the validity period and reduction mechanism as well as the presence or absence of other guarantees. From the point of view of the account party, it must be emphasized that it should pay attention to avoid situations in which several guarantees cover one risk simultaneously. Otherwise the account party can be faced several claims regarding the realization of the same risk.

I. Tender guarantee (bid bond)

The practice of requiring tender guarantees is quite common and frequently occurs in the public sector as well as in privately negotiated contracts.⁵¹ For instance, the envisaged conclusion of a construction contract or a major contract for the supply of capital goods is often safeguarded with a tender guarantee. The conditions and regulations governing the invitation for tenders invariably require potential future sellers, bidders, to procure a tender guarantee for a fixed sum of money or a percentage that mostly ranges in the margin from one to five percent of the project value.⁵² The bidding documents often contain the commercial conditions which govern the contract to be concluded. These guarantees are typically payable on demand.

A bid bond is designed to ensure that the bidder does not withdraw its bid before adjudication, and does not fail or refuse to accept the award of a contract in its favour.⁵³ Otherwise the beneficiary inviting bids will be compensated for the additional costs it may bear in re-awarding the contract to another party. The additional costs may encompass the expenses to publish new tender conditions and the expenditure of

⁴⁹ Bertrams, *Bank Guarantees in International Trade*, p. 29.

⁵⁰ Bertrams, *Bank Guarantees in International Trade*, p. 29.

⁵¹ Penn/Shea/Arora, *The Law and Practice of International Banking*, p. 263; Gmuer, *Trade Financing*, p. 194; Rowe, *Guarantees*, p. 73.

⁵² Bertrams, *Bank Guarantees in International Trade*, p. 29.

examining the specification of another party's bid. Moreover, as Bertram correctly emphasizes 'in a broader sense, requirements in respect of tender guarantees (...) are aimed at ensuring that only serious, reputable and financially sound contractors respond to the invitation for tenders, which greatly facilitates the procedures and evaluation of the various bids'.⁵⁴

Tender guarantees usually state a specific expiry date that corresponds with the expected date of adjudication. Most of the bid bonds contain an option of extending the validity period. Failing which it is to ascertain nowadays that potential beneficiaries often do not accept such bonds.⁵⁵

After the conclusion of the envisaged contract bid bonds are not allowed to be called. In principle, all tender guarantees that cover unsuccessful bids are returned at the same time, while the contracting party receives its bid bond upon signing the contract and frequently upon issuance of a performance bond.

II. Performance and maintenance guarantee (performance and maintenance bond)

Performance guarantees are issued for the period after conclusion of the contract and safeguard the position of the buyer. In many situations, the buyer situated in a foreign country is uncertain whether, for instance, the seller will be able to supply the goods sold or to satisfy its other obligations under the contract. A performance bond underwrites the contractor's obligations to complete the project correctly.⁵⁶ Often, such guarantees are issued by the same bank that handles the tender bond.⁵⁷

It must be differentiated between performance bonds issued by surety companies and performance bonds issued by banks or other financial institutions. Financial institutions guarantee the payment of a certain amount of money upon non-performance of the seller; this will usually be done in the way of a first written demand. Besides the

⁵³ Gmuer, *Trade Financing*, p. 193.

⁵⁴ Bertrams, *Bank Guarantees in International Trade*, p. 29.

⁵⁵ Bertrams, *Bank Guarantees in International Trade*, p. 30.

⁵⁶ Williams, 'On Demand and Conditional Performance Bonds', *Journal of Business Law* 1981, 8 at 9.

⁵⁷ Rowe, *Guarantees*, p. 75.

payment of money, surety companies alternatively commit themselves to the good performance of the seller's duty and guarantee satisfactory completion.⁵⁸ Potential beneficiaries prefer the issuance of bank guarantees to surety bonds.⁵⁹

The percentage of the contract value covered by the guarantee mostly ranges from five to ten percent and often reflects the respective strength of the bargaining position of the parties.⁶⁰ However, to avoid disputes, it is better to fix a certain amount and currency in the bond than to state a percentage of the underlying contract amount. Furthermore, it is advisable from the seller's point of view to include an expiry date of the bond. If it is necessary, the date can be extended.

Performance bonds are sometimes used as financing instruments: The proposed security of such bonds can be reached as well by the buyer's withholding of a part of the purchase price as security for proper performance. Since sellers regularly prefer to receive the full contract price, performance guarantees function as financing instruments.

The risks which are covered by the guarantee are often stated in general wording and amount to a description as non-performance of the seller's obligation. Von Westphalen emphasizes that 'the ambit of performance guarantees thus extends not only to the delivery of , for example, equipment, but includes the installation, contractual warranty obligations during the warranty period, ancillary and all other obligations which form part of the principal contract, **unless clearly stated otherwise**'.⁶¹

In contrast to this view, some authors contend that performance guarantees do not encompass defects which occur during the warranty period.⁶²

The former viewpoint is preferable because the text of usual performance bonds must be regarded as crucial. Thus, the term 'performance' is not confined to the phase of delivery, but is usually construed in a broader sense. Since the wording lends no support

⁵⁸ Rowe, *Guarantees*, p. 75.

⁵⁹ See chapter 2 A I.

⁶⁰ Bertrams, *Bank Guarantees in International Trade*, p. 30.

⁶¹ Von Westphalen, *Die Bankgarantie im internationalen Handelsverkehr*, p. 39.

⁶² Nielsen, 'Ausgestaltung internationaler Bankgarantien unter dem Gesichtspunkt etwaigen Rechtsmissbrauchs', *Zeitschrift für das gesamte Handelsrecht und Wirtschaftsrecht* 1983, 145 at 149.

for the latter opinion, the seller's obligations are completely encompassed in a performance guarantee, unless clearly stated otherwise.

Contracts that run for a long period of time should not be covered by a single performance bond. It is advisable for the account party, that is the seller, to have covered different phases or segments of the contract in several guarantees, whose respective covered percentage of contract value is less high. If problems arise in a certain phase and, thus, a bond's call may occur, the account party does not face such a high risk of financial loss. This procedure is, for example, useful in turnkey contracts that include the actual putting into operation of the plant, staffing, training and monitoring of management as well as the transfer of technology and know-how. However, the disadvantage for the account party is that the total costs of issuing several bonds can be higher. To avoid such high costs, Bertrams suggests that 'a similar arrangement, but one which is riskier for the exporter, can be achieved by one performance guarantee covering the entire project, but allowing for a reduction of the maximum amount upon completion of the successive stages'.⁶³ Disputes may arise whether the prerequisites for a reduction have occurred.

A separate maintenance bond can be issued which covers the warranty period and serves the same purpose as a performance guarantee. But as mentioned, the account party should make sure that the same risk is not covered by several guarantees.⁶⁴ Therefore, it is advisable from the viewpoint of the account party to incorporate a clause which stipulates that the successive guarantee does not enter into force until the return of the proceeding guarantee.

Maintenance guarantees tend to be issued for a fixed percentage of the contract value which is considerably lower than that of the performance guarantee.⁶⁵ Maintenance guarantees ensure that the seller remedies any defects which become apparent after delivery of the goods or after completion of the plant.

⁶³ Bertrams, *Bank Guarantees in International Trade*, p. 31.

⁶⁴ See chapter 2 C.

⁶⁵ Bertrams, *Bank Guarantees in International Trade*, p. 32.

As performance bonds, maintenance guarantees are often used as financing instruments: The buyer, that is the beneficiary of the issued bond, is persuaded not to withhold a certain amount of money as security for repairs or supplemental works which have to be rendered by the seller. In this respect, the buyer's released amount of money is equal with the amount payable under the guarantee.

This guarantee is typically payable on first written demand.

III. Advance payment guarantee (repayment bond)

In most major projects the seller as contractor requires an advance payment on the contract price to finance initial operations. Usually the advance payment is intended to be used for the purchase of equipment or certain activities such as the hiring of workers, transportation of materials and customs clearances. The amount of down payment to the seller frequently ranges from five to thirty percent of the contract value.⁶⁶ Correspondingly, the repayment guarantee covers the same amount.

The amount of advance payment is often a reflection of the seller's competitive strength or technological advantage.⁶⁷ It is, for instance, common to obtain larger advance payments on sophisticated projects with a high technological content.⁶⁸

The account party should be aware of the risk that it faces in respect to the wording of the bank guarantee. Often the specific risk covered by a repayment guarantee is described in general wording, that is non-performance. Hence, the beneficiary might be entitled to call the guarantee if the contractor has failed to utilize the advance payment to certain specific activities to be carried out in the early stages of execution or if the contractor has failed to carry out the contract up to the extent for which he received advance payments.

Thus, if the payment mechanism is triggered by the term 'non-performance', the repayment guarantee can be called for the full amount and in the same circumstances as a corresponding performance guarantee. This approach reflects the basic principle of

⁶⁶ Rowe, *Guarantees*, p. 76; Bertrams, *Bank Guarantees in International Trade*, p. 32.

⁶⁷ Gmuer, *Trade Financing*, p. 198.

⁶⁸ Construction of petrochemical plants, telecommunication systems etc.

guarantees that they can be called provided that the terms and conditions as specified are met.⁶⁹

Repayment bonds often contain a reduction clause. These clauses typically provide for a reduction of the maximum amount upon evidence of progressive performance.

In practice, the contractor requests a confirmation from the employer that the amount outstanding under the advance payment guarantee shall be reduced. After receiving the confirmation, the contractor informs its guarantor and obtains relief or proportionate reduction from the recourse obligation of the guarantor.

The outstanding amount can actually be reduced to zero prior to final completion of the contract, but this is not often the case.⁷⁰ Usually if the advance payment guarantee ceases to have effect, a performance guarantee will secure the subsequent phase of the contract.

If the repayment bond is triggered upon non-performance of the contract, the repayment bond operates as a variant of a performance guarantee. However, it is necessary to differentiate: The purpose of advance payment guarantees is to secure repayment of the down payment. Performance bonds, on the other hand, secure compensation for losses other than the advance payment which result from breach of contract.

The object of a repayment guarantee is broader than that of a performance guarantee:⁷¹ Repayment guarantees can also be called when the contract is cancelled by mutual consent, if the contract has not entered into force or the execution is hampered because of *force majeure* or if the contract turns out to be void.

From the account party's point of view, it is advisable that the advance payment guarantee only enters into force after receipt of the advance payment. In some countries,⁷² beneficiaries require interest to be added to any capital sum repaid.

IV. Retention guarantee (retention money bond)

⁶⁹ Juutinen, 'Methods of Payment and Exporter's risk exposure', LLM-Dissertation, 1999, p .8.

⁷⁰ Gmuier, Trade Financing, p. 198.

⁷¹ Bertrams, Bank Guarantees in International Trade, p. 33.

Advance payments are made in respect of undertakings to be carried out in the future, while stage payments are made in respect of work completed. In general, project agreements provide for stage payments to be made as work progresses. Payment is usually triggered by presentation of a progress certificate for the relevant stage certified by the project engineer. The employer is ordinarily entitled to retain a percentage of the instalments, normally between five and ten percent, as security for defects that become apparent at a later stage.⁷³ Traditionally, the so-called retention money was placed in an escrow account and made available to the contractor at a certain time - usually one year - after completion of the contract.

Nowadays, the procedure has changed because it has not been very practicable for the contractor who has only partially received payment on its certificate of progress. To receive the full amount of money, the contractor provides a retention guarantee in favour of the employer against which all retained money will be released.

Retention guarantees have a similar purpose to repayment and maintenance guarantees in so far as they ensure a refund of payments made by the employer.

However, a maintenance guarantee applies to the project as a whole, while a retention guarantee is issued in respect of each stage during the continuance of the work.

Unlike repayment guarantees containing a reduction mechanism, the maximum amount payable under a retention guarantee may increase in accordance with the successive releases of the retention money.

In addition, retention bonds may resemble performance bonds by indemnifying the employer if the contractor fails to complete the project.

Thus, there are often only slight differences between several types of bonds.

V. Payment guarantees and standby letters of credit

A main category of bank guarantees is primarily utilized for the security of specific financial obligations, arising for example out of sale contracts, lease and construction contracts. These special types of bank guarantees are called payment guarantees or

⁷² For example Russia.

⁷³ Rowe, *Guarantees*, p. 76; Penn/Shea/Arora, *The Law and Practice of International Banking*, p. 268.

standby letters of credit⁷⁴. Payment guarantees are akin to the traditional documentary credit⁷⁵ which is a synonym for a letter of credit.⁷⁶ Both financial instruments are independent from the underlying contract and their conditions of payment have a documentary nature.

In recent years, the demand for payment guarantees has increased in order to assure payment in sale transactions, while the demand for documentary credits has decreased correspondingly.⁷⁷ The significant difference between documentary credits and payment guarantees is that the bank's payment under a documentary credit takes place in the ordinary course of events as contemplated by all parties concerned, while the beneficiary of a payment guarantee is expected to seek and obtain payment from the buyer at first. Factually, the beneficiary can only call the guarantee in the event of non-payment. In the words of Bertrams: 'The traditional letter of credit serves primarily as a means of payment in the contemplated execution of the transaction, while a payment guarantee (...) serves as security for payment in the event of the account party's default'.⁷⁸

The reasons for the increasing trend in respect of payment guarantees in international trade are diverse:

In general, the utilization of payment guarantees generates lower costs than the involvement of letters of credit: One payment guarantee usually secures the payment for several sale transactions towards a certain buyer. On the other hand, a letter of credit only covers a single transaction⁷⁹. Hence, it is necessary to issue several letters of credit where there are different transactions towards the same buyer. This produces higher expenses.

⁷⁴ Today, standby letters of credit sometimes secure non-financial obligations too. See chapter 2 B IV; Symons, 'Letters of Credit', *Tulane Law Review* 1980, Vol. 54, 338 at 338.

⁷⁵ Penn/Shea/Arora, *The Law and Practice of International Banking*, p. 287.

⁷⁶ Hugo, 'Documentary Credits', *LLD-Dissertation*, 1996, p. 9; Bradgate/White, *Commercial Law*, p. 292.

⁷⁷ Bertrams, *Bank Guarantees in International Trade*, p. 34.

⁷⁸ Bertrams, *Bank Guarantees in International Trade*, p. 34.

⁷⁹ The exception is a revolving credit which is not for a fixed amount or time, but may revolve around value or time. See for details Gmuer, *Trade Financing*, p. 23.

The utilisation of a payment guarantee is rather the exception than the rule, whereas the payment mechanism of a letter of credit is usually triggered. Therefore, bank charges for triggering payment under a letter of credit are always due, while corresponding charges in case of a payment guarantee are mostly not caused.

Bank charges are higher in the context of a documentary credit because the documents on which a documentary credit is based are usually more extensive than those of a payment guarantee and it takes more time to examine them. Thus, banks often refuse to depend payment guarantees on the submission of a variety of documents. If the customer wants to depend the triggering of payment on a variety of documents, it shall apply for a letter of credit.⁸⁰ Besides the higher costs, the account party should be aware that the procurement of more documents generates a lower risk exposure in respect to the proper fulfilment of the beneficiary's obligations.

The higher demand for payment guarantees is also based on today's trade practice:

If the seller is the beneficiary of a payment guarantee, banks are less reluctant to give credit and possibly at lower rates than without a payment guarantee.⁸¹ Therefore, sellers insist on the issuance of payment guarantees because they have to finance their own operations before receiving the purchase price. Purchasers, conversely, are mostly reluctant to render advance payments, but prefer payment on open account.

CHAPTER 3 – THE OPERATION OF AUTONOMOUS BANK GUARANTEES WITH SPECIAL REFERENCE TO THE ACCOUNT PARTY'S RISK EXPOSURE AND ITS MANAGEMENT

A. Doctrine of independence

Bank guarantees are based on the important principle of independence. By explaining that principle, it must be emphasized that the meaning of independence varies according to the selected point of reference.

⁸⁰ Bertrams, *Bank Guarantees in International Trade*, p. 34.

⁸¹ Bertrams, *Bank Guarantees in International Trade*, p. 34.

I. The relation between bank and beneficiary

The relation between bank and beneficiary is, on the one hand, independent from the bank's mandate relationship with the account party and, on the other hand, from the contract between principal debtor (account party) and creditor (beneficiary). The bank as guarantor is directly bound towards the beneficiary and cannot, in principle, raise defences which emanate from the two other legal relationships.⁸² In first demand guarantees, the question whether the principal debtor has fulfilled its obligations towards the creditor or whether the creditor is entitled to call the bond for the requested amount is not a relevant issue between bank and beneficiary. Rather it is solely decisive that the terms and conditions of the guarantee are met. In such circumstances the beneficiary is entitled to claim payment without showing default in any other way than described in the guarantee.

If the bank issues a conditional bond, the situation is completely different. As Bertrams points out 'the true significance and value of the principle of independence depends entirely on the particular type of conditions of payment'.⁸³ For instance, if a conditioned bond stipulates the submission of a judicial or arbitral award establishing the principal debtor's breach of contract, the rule of independence is of little practical effect. In such circumstances, the guarantee is identical with a suretyship.

It has been argued that the principal contract should not be disregarded so readily: 'The facts of each case would have to be considered, and where the underlying contract had been lawfully avoided or where there was failure of consideration between buyer and seller, for which the seller undertook to procure the issue of the performance bond, there was no reason why, as between buyer and seller, the seller should be unable to prevent a call upon the bond.'⁸⁴ Another opinion suggests that the guarantor should be discharged from its obligation of payment in exceptional cases, that is, for example, if

⁸² Von Houtte, *The Law of International Trade*, p. 300.

⁸³ Bertrams, *Bank Guarantees in International Trade*, p. 9.

⁸⁴ Eveleigh L.J. in *Penn/Shea/Arora, The Law and Practice of International Banking*, p. 273.

the underlying contract is against international public policy.⁸⁵ A further point of view states that ‘the guarantor is no longer bound when the court has pronounced the dissolution or the avoidance of the underlying contract’.⁸⁶ However, the mentioned opinions cannot be followed because their approaches eviscerate the bank’s obligation of payment if the conditions, stated in the guarantee, are met. The guarantor’s promise in a first demand bond, for example, is to pay a certain sum of money without consideration of the principal contract. That autonomous commitment must be decisive and cannot be undermined by contemplating the underlying contract in certain circumstances.⁸⁷ Otherwise, the beneficiary would be unfairly treated and this treatment would be in contradiction to the bank’s and beneficiary’s intention by concluding the independent contract of guarantee.

II. The relation between bank and account party

The account party instructs the bank to issue an independent guarantee. Subsequently, the bank effects payment exclusively on the basis of the terms and conditions of that bond. Accordingly, the bank honours the instructions of the account party and the latter has to reimburse the former.

The account party cannot invoke any objections originating from the principal contract to the creditor. The bank’s undertaking is confined to the issuance of the guarantee as requested and it is not involved in the underlying contract. If the account party could raise defences stemming from that contract, the bank would run the risk of receiving no indemnity for the payment to the beneficiary. This would be unfair because the account party has determined the conditions, triggering the payment mechanism, towards the bank. Therefore, the account party has to bear the risk of a(n unfair) call if the conditions of the guarantee are met. Thus, the bank’s relationship with the account party must be independent from the underlying contract.

B. Inherent risks of autonomous bank guarantees for the account party and its preventive management

⁸⁵ Von Houtte, *The Law of International Trade*, p. 309.

⁸⁶ Von Houtte, *The Law of International Trade*, p. 309.

⁸⁷ Affirmative Penn/Shea/Arora, *The Law and Practice of International Banking*, p. 273.

I. Risks and the bank's position

1. Risks involved

Pursuant to a systematic approach, it is necessary to identify some of the concomitant risks of independent bank guarantees before dealing with the management of such risks.⁸⁸

The account party runs a considerable risk in providing the beneficiary with the most frequently used form of a guarantee, that is the first demand bond⁸⁹: In light of the principle of independence, there exists the significant risk that banks are bound to honour every beneficiary's call of the guarantee without questioning whether the call is justified at all. This rule was expressed by Mr. Justice Kerr in *Harbottle Ltd. v. National Westminster Bank Ltd.* (1978) Queen's Bench 146 at 155:

'It is only in exceptional cases that the courts will interfere with the machinery of irrevocable obligations assumed by banks. They are the life-blood of international commerce. (...) They (commitments of banks) must be allowed to be honoured, free from interference by the courts. Otherwise, trust in international commerce could be irreparably damaged'.

The account party of a first demand bond incurs another risk too. This will be explained at best by a comparison with the similar risk involved in a letter of credit. The beneficiary of a letter of credit has to produce documentary evidence of certain incidents in respect to the fulfilment of its obligations, for example the shipment of goods or the services rendered. Conversely, the beneficiary of an unconditional bond may only need to produce a written demand in order to receive payment. Hence, in the latter event the risk of (partial) failure of proper performance is, from the viewpoint of the account party, higher than in case of a documentary credit.

⁸⁸ Particular risks will be pointed out in the context of preventive means for the management of risks.

⁸⁹ See chapter 2 B II.

In addition, the account party is confined to the rights under the principal contract when it is of the opinion that the beneficiary called the bond unfairly: Courts do not usually interfere in the relationship of bank and beneficiary.⁹⁰ Moreover, the bank does not breach the contract to the account party if the conditions of the guarantee are met and the bank complies with the demand for payment.

The terms of the contract, especially the choice of law and the jurisdiction clause, are frequently dictated by the foreign beneficiary who is often the economically stronger party.⁹¹ Therefore, in almost all cases the account party has to institute proceedings in the beneficiary's country and under the law of that country. The likelihood of obtaining redress in such circumstances is very small.

There is another risk in the context of bank guarantees involved, while the situation in respect to a letter of credit is unambiguous: If the seller delivers defective goods, it has to compensate the buyer. Conversely, it is not so clear how there has to be dealt with an unfair call in the situation of a first demand bond.⁹² It can be argued that the account party has tacitly accepted the beneficiary's right to call for any reason. Otherwise, the account party would have to insist on a conditional guarantee in order to make sure that the beneficiary fulfils its obligations properly before it calls the bond.

2. Bank's obligation to inform

Theoretically, the obligation of the bank to advise of the inherent risks of bank guarantees can arise by express or implied terms or because the bank owes its customer a fiduciary duty. In practice, when a bank issues an independent bank guarantee it receives from its customer an agreement to indemnify the bank in the event of a bond's call. Loke points out that 'the indemnity agreement, as a rule, does not contain any terms, expressed or implied, as to the bank's obligation or its duty to its customer'.⁹³ Therefore, the bank does usually not have an express or implied obligation to inform.

⁹⁰ See above in this section.

⁹¹ Jordan, 'Guarantee Bonds: Their use in International Contracts', *International Contract Law and Finance Review* 06/1980, 201 at 205.

⁹² Jordan, 'Guarantee Bonds: Their use in International Contracts', *International Contract Law and Finance Review* 06/1980, 201 at 205

⁹³ Loke, 'Standby Credits and Performance Bonds: The Lesson of the Iranian Experience' in Chinkin/Davidson/Ricquier, *Current Problems of International Trade Financing*, 283 at 293.

It is questionable whether banks are obliged to inform their customers about the risks of the demanded bond because of a fiduciary duty. National laws are frequently unclear in respect of the conclusion of such a duty.⁹⁴

However, there are considerable arguments that banks do have a fiduciary duty to inform.

It is submitted that bankers, and not lawyers or other persons, are the only ones whom the principal debtor consults when a bond is required. Therefore, it is adequate to oblige bankers to provide the principal debtor with a minimum standard of information that includes the inherent risks of the demanded instrument.⁹⁵

Bankers, in addition, deal with bonds every day as part of their business. They have a wide range of facts available regarding issuance, handling and calling of bonds in various situations. Thus, they should know about the common problems arising in the context of bank guarantees. In *Banner v. Town of Dayton* it was held:⁹⁶ 'It requires no extended legal philosophy to justify holding a professional man, who is aware of a danger or difficulty attendant in an undertaking by him, obligated at minimum to discuss the difficulties with his client as a basis for avoiding or ameliorating the situation.' Only in exceptional cases, it might be unjustified to impose on banks a fiduciary duty to advise their customers in respect of the risks involved in bank guarantees, namely if the customer is likely to be a 'businessman of full age and competence'.⁹⁷ Such extraordinary circumstances are satisfied, for example, if the customer is a banker itself or a businessman dealing with bonds most of the time.

In addition, banks often advertise that they are experts in international trade financing. Thus, they have to know of the problems associated with independent bank guarantees. Even if a local branch does not have actual knowledge, it has the duty to receive that

⁹⁴ See for English law: Ellinger, 'Fraud in Documentary Credit Transactions', *Journal of Business Law* 1981, 258 at 258.

⁹⁵ Loke, 'Standby Credits and Performance Bonds: The Lesson of the Iranian Experience' in Chinkin/Davidson/Ricquier, *Current Problems of International Trade Financing*, 283 at 292.

⁹⁶ *Banner v. Town of Dayton*, Wyo. (1971) 474 P. 2d 300 at 306 et seq.

⁹⁷ A similar approach was held in *Williams & Glyns Bank Ltd. v. Barnes* (1981) *Com. Law Review* 205 at 209.

information from its branch or headquarter.⁹⁸ The customer, on the other hand, can expect that banks are prepared to share their special knowledge in circumstances of an application for a bond. Thus, there are sound arguments that reinforce a fiduciary duty to inform the customer about immanent risks of bank guarantees.⁹⁹

The bank's duty to inform encompasses the aspect that the bank will be inclined to pay the beneficiary whose procured documents comply with the bond's wording even though the calling of the credit is in the customer's eyes wrongful. Furthermore, the client must be notified that there are only few remedies for restraining the bank from paying.¹⁰⁰

It is questionable if the bank has the further duty to inform its client before making payment. A duty exists, of course, in situations in which the parties agreed expressly to such a procedure. Otherwise, there is no obligation to notify the customer before payment.¹⁰¹

Banks do not have such an obligation because they have the duty to inform their clients about the inherent risks of bonds. This includes the trigger of the payment mechanism. If the client is well informed, there is no reason for complain should it insist on the bond and ultimately has to pay a heavy price for the demanded instrument.

In addition, the bank pays pursuant to its own independent commitment. Hence, it has the right to settle its debt whenever it wants without the need of informing a third party, that is the principal debtor. If a bank nevertheless informs its customer voluntarily, it is a matter of good business practice and mirrors courtesy.¹⁰²

II. Preventive countermeasures

⁹⁸ Loke, 'Standby Credits and Performance Bonds: The Lesson of the Iranian Experience' in Chinkin/Davidson/Ricquier, *Current Problems of International Trade Financing*, 283 at 292.

⁹⁹ Affirmative Penn/Shea/Arora, *The Law and Practice of International Banking*, p. 279, footnote 61 and von Houtte, *The Law of International Trade*, p. 306.

¹⁰⁰ Loke, 'Standby Credits and Performance Bonds: The Lesson of the Iranian Experience' in Chinkin/Davidson/Ricquier, *Current Problems of International Trade Financing*, 283 at 295.

¹⁰¹ *Esal (Commodities) Ltd. v. Oriental Credit Ltd.* (1985) 2 Lloyd's Law Reports 546 at 552; Chong, 'The Abusive Calling of Performance Bonds', *Journal of Business Law* 1990, 414 at 423; Penn/Shea/Arora, *The Law and Practice of International Banking*, p. 279. - Dissenting opinion in Houtte, *The Law of International Trade*, p. 306.

¹⁰² *Esal (Commodities) Ltd. v. Oriental Credit Ltd.* (1985) 2 Lloyd's Law Reports 546 at 553.

It is noteworthy that the implementation of the following advices essentially depends on the respective strength of the bargaining position of the parties.

1. Provisions in the bond wording

During the stage of negotiating the principal contract, the account party and the beneficiary agree on the basic content of a bond. This must be done by taking the form and content of prescribed government regulations into account that exist in certain events.¹⁰³ Often, in the rush and tension of arranging and finalising a deal, bonds appear peripheral. Account parties do not consider that guarantees frequently represent a considerable percentage of the project value.¹⁰⁴ They are rather of the opinion that bonds are a mere formality.

The majority of bonds are not cashed. However, as Rowe emphasizes, ‘the power to call the bond gives the beneficiary a powerful weapon in any renegotiation of contract terms or discussion of prospective claims’¹⁰⁵. In addition, the more unconditional the guarantee is, the more powerful the beneficiary’s weapon becomes. Banks honour the call of an unconditional bond in light of the principle of independence even if the account party protests.

Besides the legal principle of independence, there is an important economic aspect for honouring such a call: ‘Bankers place their international reputation on the line when giving first demand bonds, and it has become a basic proposition in international trade that nothing, or nothing much, should come between a bank and its obligation to make payment when demand is made.’¹⁰⁶ Therefore, the account party should always try to negotiate for conditional provisions in a bond even if it thinks that guarantee conditions are non-negotiable owing to the economic strength of its vis-à-vis contracting partner. If the contracting partner is not willing to allow the issuance of a conditional bond, it is advisable to offer a discount for a conditional payment mechanism. Loke advises in respect to the documentary conditions: ‘Even if it is not possible to obtain certification

¹⁰³ See for details: Rowe, *Guarantees*, p. 59.

¹⁰⁴ See chapter 2 C.

¹⁰⁵ Rowe, *Guarantees*, p. 59.

from an independent third party, certification from the beneficiary might be good enough, because, if it is false, it may provide grounds for injunction on the grounds of fraud.¹⁰⁷

One of the most important issues in negotiating the terms of a bond is how the payment mechanism is triggered. Even if it is trite, it is nevertheless noteworthy that the facts of the respective situation affect the negotiation about the conditions which trigger the payment mechanism. Hence, the subsequent recommendations must be regarded as general and illustrative guidelines.

In case of a bid bond it is recommended that it should be callable in two circumstances only:

- where the tenderer has been awarded the contract, but has indicated he does not wish to proceed or in a situation
- in which the tenderer has been awarded the contract, but the contract has not come into force due solely to the tenderer's failure to provide another bond required as part of such coming into force provisions.¹⁰⁸

In case of a performance bond it is recommended that the bank should not be allowed to honour a call unless

- accompanied by a court or arbitration award in the beneficiary's favour or
- an admission by the account party of its breach of contract and an agreement to the amount claimed.¹⁰⁹

¹⁰⁶ Penn/Shea/Arora, *The Law and Practice of International Banking*, p. 277, 279 and the same approach is mentioned in Wheble, "Problem Children"-Standby Letters of Credit and simple first demand Guarantees', *Arizona Law Review*, Vol. 24, no. 2, 301 at 308.

¹⁰⁷ Loke, 'Standby Credits and Performance Bonds: The Lesson of the Iranian Experience' in Chinkin/Davidson/Ricquier, *Current Problems of International Trade Financing*, 283 at 289 et seq.

¹⁰⁸ Jordan, 'Guarantee Bonds: Their use in International Contracts', *International Contract Law and Finance Review* 06/1980, 201 at 206.

¹⁰⁹ Jordan, 'Guarantee Bonds: Their use in International Contracts', *International Contract Law and Finance Review* 06/1980, 201 at 206.

By negotiating the wording of the guarantee, the account party should pay attention that the required documents which trigger the payment mechanism are precisely specified. Otherwise, the bank faces an investigation into the default of its customer on the basis of the facts procured by the beneficiary. The bank may take the view that, with guarantee bonds as with letter of credits, its role is to check documentation and not its customer's performance. Subsequently, the bank may well treat the guarantee as unconditional because of the lack of specified documentation on the account party's default.

Terms on a definite expiry date **and** the subsequent return of the bond to the guarantor should be incorporated in the guarantee.

The expiry date should be definite. Otherwise, the account party could be threatened with the well known sentence 'extend or pay'.¹¹⁰ According to this sentence, the account party runs the risk of a bond's call if it does not cause the extension of the bond's validity date.

Even if the guarantee is expired, the bank and the account party can never be certain that a claim under the bond will not be made so long as the guarantee is retained by the beneficiary. Some national laws, for instance Morocco, Syria, Turkey, determine the validity of the bond irrespective of any date on its face and, thus, a guarantee remains into force until its return to the bank and the account party respectively.¹¹¹ Furthermore, the account party remains liable for the payment of fees due in the meantime.¹¹²

To encounter the named risks, the account party is well advised to incorporate a clause according to which a reduction of the maximum bond's amount takes place. This undertaking limits the amount of money that is at stake for the account party. The reduction mechanism usually depends on the progressive performance of the contract or, in an advance payment guarantee, corresponds with the value of goods supplied and services rendered. However, the trend during the last decades has been that more reduction clauses have been incorporated in advance payment bonds than in

¹¹⁰ Jordan, 'Guarantee Bonds: Their use in International Contracts', *International Contract Law and Finance Review* 06/1980, 201 at 207.

¹¹¹ Jordan, 'Guarantee Bonds: Their use in International Contracts', *International Contract Law and Finance Review* 06/1980, 201 at 207.

performance bonds even if the same arguments for the incorporation of a reduction mechanism can be raised.¹¹³

It is noteworthy that a reduction of the maximum amount to zero pursuant to a reduction clause does not by itself bring about the expiry of the guarantee. Rather an expiry of the bond can only be generated by linking the both different issues together. Hence, the terms of the guarantee frequently provide that the bond expires as soon as the maximum amount of the guarantee has been reduced to zero.

The account party, in addition, is well advised to oblige the beneficiary to give advance notice of its intention to make demand under the guarantee.¹¹⁴ The advance notice should be given to both the account party and the bank and for a specified period of time before the envisaged call will take place. This procedure improves the account party's position because it gives time for the settlement of disputes or, otherwise, to institute court proceedings.

2. Provisions in the principal contract wording

The account party should be aware that in cases of the most wanted first demand bond it is confined to the rights under the principal contract if the beneficiary calls the bond arbitrarily.¹¹⁵ Hence, the wording of the underlying contract is of paramount importance.

In light of the independence principle, on the other hand, the wording does not safeguard the account party from the duty to reimburse the bank if a bond is called capriciously and the bank honours the demand for payment because the conditions of the guarantee are formally met. The provisions of the principal contract are rather important in arbitration or legal proceedings in order to strengthen the account party's position versus the beneficiary by contending an unfair call.

¹¹² Loke, 'Standby Credits and Performance Bonds: The Lesson of the Iranian Experience' in Chinkin/Davidson/Ricquier, *Current Problems of International Trade Financing*, 283 at 288 et seq.

¹¹³ Jordan, 'Guarantee Bonds: Their use in International Contracts', *International Contract Law and Finance Review* 06/1980, 201 at 207 and Bertrams, *Bank Guarantees in International Trade*, p. 89.

¹¹⁴ Loke, 'Standby Credits and Performance Bonds: The Lesson of the Iranian Experience' in Chinkin/Davidson/Ricquier, *Current Problems of International Trade Financing*, 283 at 290.

¹¹⁵ See chapter 3 B I.

In addition, the wording of the underlying contract is crucial for the wording of the bond: The account party instructs its bank to issue a bond according to the terms which stem from the principal contract with the creditor.¹¹⁶ By negotiating the principal contract, it is accordingly advisable for the account party to incorporate some protective provisions that should correspond with the terms of the guarantee, namely the given recommendations for the bond wording.¹¹⁷

Furthermore, the provisions that should be incorporated in the underlying contract depend on the envisaged guarantee. The following section encompasses examples for the frequently used bid and performance bonds:

In the event of a bid bond, it must be pointed out that the account party runs the risk that its bid will be rejected as non-conforming if the account party suggests any amendments of the bidding documents.¹¹⁸ Thus, the bidder should be aware of the precarious situation by incorporating terms in its bid.

Besides the given recommendations for the bond wording, the tender response should also include provisions in respect to the account party's maximum liability and the discharge of all liability.¹¹⁹ This is necessary in order to limit the scope of the account party's obligations.

It is particularly important that the account party meets certain precautions for the settlement of disputes¹²⁰ because the legal basis for an action versus the beneficiary is the underlying contract. Therefore, the underlying contract should fix which courts have jurisdiction or should select an arbitration procedure. If nothing is stated, the account party often has to sue the beneficiary in its country. Furthermore, the principal contract should encompass a choice of law clause that is of similar significance as a choice of

¹¹⁶ See chapter 2 B III 2.

¹¹⁷ See chapter 3 B II 1.

¹¹⁸ See chapter 2 C I.

¹¹⁹ See for details: Jordan, 'Guarantee Bonds: Their use in International Contracts', *International Contract Law and Finance Review* 06/1980, 201 at 208.

¹²⁰ Rowe, *Guarantees*, p. 60.

forum for disputes. The account party is advised to choose a set of rules with which it is familiar.

The contract wording for a performance bond needs additional provisions that do not apply to the principal contract of a bid bond: The contract wording should stipulate that the performance bond will be only issued if the principal contract enters into force. Thus, all conditions precedent of the underlying contract have to be fulfilled prior issuance of the bond. Without this link, there is the risk that the guarantee is issued without an effective underlying contract.¹²¹ Accordingly, the account party could not derive any rights from that contract in subsequent arbitration or legal proceedings.

Furthermore, it is from the account party's viewpoint advisable to limit the circumstances in which the performance guarantee can be called. Usually, a performance guarantee ensures the proper fulfilment of all the principal debtor's obligations. In practice, however, it is possible to limit the calling of a guarantee to those substantial breaches of contract according to which a termination of the entire contract would be admissible.¹²²

Finally it has to be pointed out that the account party should pay attention that the contract wording and the wording of the bond are as identical as possible.¹²³ The rationale is that the account party runs the additional risk to be liable on the basis of the underlying contract if its wording goes beyond the wording of the guarantee. The bank, conversely, is not affected and bound by the provisions of the principal contract.

3. Recourse to third parties

a. Recourse to insurance institutions

¹²¹ This was the problem in *Harbottle v. National Westminster Bank* (Q.B.D. 3 W.L.R. 752) and *Edward Owen v. Barclay's Bank* (C.A. 3 W.L.R. 764).

¹²² Jordan, 'Guarantee Bonds: Their use in International Contracts', *International Contract Law and Finance Review* 06/1980, 201 at 208.

¹²³ Loke, 'Standby Credits and Performance Bonds: The Lesson of the Iranian Experience' in Chinkin/Davidson/Ricquier, *Current Problems of International Trade Financing*, 283 at 289.

The account party can approach certain risks by insuring itself against such risks. This way of risk management is an important instrument for the promotion of international trade and is offered by private or government agencies.¹²⁴ Private insurance companies are sometimes more advantageous because they are less restricted than government agencies, for example in respect of the exporter's nationality or the origins of the goods.¹²⁵

According to the contract of insurance, the respective risk is passed from the insured (principal debtor) to the insurer.¹²⁶ The drawbacks of this undertaking are increasing costs of the proposed contract¹²⁷ and the community is made liable for the consequences of a bond's call¹²⁸.

The main object of insurance contracts is to insure the principal debtor against the risk of non-payment caused by certain events. These events are various and may differ from the respective insurance institution. The following events are illustrative:

The principal debtor is insured against the so-called 'commercial risk'. This risk includes the creditor's insolvency on which the subsequent non-payment is based.¹²⁹

Moreover, the contract of insurance covers the so-called 'political risk'.¹³⁰ The non-payment as consequence of political or economic events encompass currency exchange restrictions, shortage of currency or any other political or economic action by the government in the creditor's country and also war and natural disasters.¹³¹

However, the main principle of insurance contracts is that the principal debtor is not insured if the non-payment is caused owing to its own breach of contract.

The insurance institutions also offer protection against unfair calls of bonds in certain events. Insurance cover, however, does not exist if the insured was in default, except if

¹²⁴ Rowe, *Guarantees*, p. 90; Institutions are, for instance, the German Hermes-Kreditversicherung, the U.K.'s Export Credits Guarantee Department (ECGD) or Lloyd's of London.

¹²⁵ Bertrams, *Bank Guarantees in International Trade*, p. 359.

¹²⁶ Goode, 'Surety and On-Demand Performance Bonds', *Journal of Business Law* 1988, 87 at 88.

¹²⁷ Penn/Shea/Arora, *The Law and Practice of International Banking*, p. 285.

¹²⁸ Rubino-Sammartano, 'Performance Bonds: Primary or Secondary Obligations?', *International Business Lawyer* 03/1985, 125 at 127.

¹²⁹ Bertrams, *Bank Guarantees in International Trade*, p. 359.

¹³⁰ Loke, 'Standby Credits and Performance Bonds: The Lesson of the Iranian Experience' in Chinkin/Davidson/Ricquier, *Current Problems of International Trade Financing*, 283 at 290.

¹³¹ Bertrams, *Bank Guarantees in International Trade*, p. 359.

its non-performance is based on specified political reasons beyond its control.¹³² An arbitrary call is generally given in the following circumstances.¹³³

- The beneficiary is not entitled to call the bond because the principal debtor has complied with the terms of the underlying contract and has not been in default or is in default owing to political reasons beyond its control.
- In the case of a public beneficiary, the call is politically or economically motivated and in the event of a private beneficiary, the beneficiary's government has instructed the call.

In practice, however, it is often difficult to ascertain whether the criteria for a loss, covered in the insurance contract, are satisfied. In particular, the question of the principal debtor's default gives rise to disputes. The different insurance institutions have various philosophies under which circumstances payments are made. For instance, the Export Credits Guarantee Department (ECGD) mostly refuses payments if the beneficiary indicates in any way dissatisfaction with the principal debtor's performance. If the circumstances satisfy the criteria of a covered loss, the insurer's payment will usually¹³⁴ not cover the full amount of the loss but a certain percentage only. After payment, the insurer is subrogated in the insured's legal position towards the beneficiary, although the subrogation does frequently not have considerable consequences in practice.¹³⁵

b. Recourse to sub-contractors

The account party in major 'turn-key' contracts is well advised to transfer as many as possible of its contractual risks to its principal sub-contractors. This undertaking is especially recommendable where completion of the main contract is critically contingent on those sub-contractors. Jordan suggests that 'where the main contractor is required to give unconditional guarantees (...) he should consider asking his sub-contractor to issue him with bonds in the same terms as those he is being asked to issue

¹³² Penn/Shea/Arora, *The Law and Practice of International Banking*, p. 285.

¹³³ See for details: Bertrams, *Bank Guarantees in International Trade*, p. 360.

¹³⁴ The exception is the ECGD policy.

under the main contract'.¹³⁶ Thus, the main contractor can pass its exposed contractual risk along the line. On the other hand, there is the danger that the sub-contractor's offer will be inflated by requiring the issuance of a bond. However, the final decision for or against such an undertaking must be based on the facts of the single case. If the sub-contractor, for example, is a reputable company with normal bank overdraft facilities, the additional costs involved should not affect the offer unreasonably.¹³⁷

4. Consideration in the contract price

The account party can consider the risk of an unfair call by building it into the price of the contract.¹³⁸ Insofar this risk is evaluated in the same way as other contract risks too. The concrete impact on the contract price depends, of course, on the value of the guarantee required and the competitive position of the account party.

5. Blocked bank account

The account party's position can be strengthened if the guarantee sum is paid into a blocked bank account in case of a contentious call.¹³⁹ After the account party won the subsequent arbitration or legal proceedings, the blocked money is released in its favour. This procedure conveys the benefit that the account party does not face the risk of the beneficiary's insolvency.

6. Dividing the guarantee

It is advisable to provide the beneficiary with different smaller bonds than with a single bond whose value is very great. The smaller bonds can be linked to several stages of the contract and should expire after proper performance of the respective stage. This

¹³⁵ Bertrams, *Bank Guarantees in International Trade*, p. 362.

¹³⁶ Jordan, 'Guarantee Bonds: Their use in International Contracts', *International Contract Law and Finance Review* 06/1980, 201 at 210.

¹³⁷ Jordan, 'Guarantee Bonds: Their use in International Contracts', *International Contract Law and Finance Review* 06/1980, 201 at 210.

¹³⁸ *Edward Owen Engineering Ltd. v. Barclay's Bank International Ltd.* (1978) 1 Queen's Bench. 159 at 176.

¹³⁹ Rowe, *Guarantees*, p. 73.

undertaking reduces the exposure to unfair calls step by step in proportion to performance of the entire contract.¹⁴⁰¹⁴¹

7. Bond in favour of the account party

The account party is well secured if the beneficiary itself agrees to the issuance of a guarantee against its own unfair calling of the account party's guarantee.¹⁴²

If the beneficiary calls the bond arbitrarily, the account party will bring arbitration or legal proceedings against the former. In case of a court or arbitration award in the account party's favour, it will call the bond that has been issued for its benefit and, thus, will be compensated for the beneficiary's unfair call.

However, the beneficiary will agree to this undertaking only rarely, for example, if the account party's bargaining power is extraordinarily strong. In addition, this device produces additional costs owing to the issuance of another bond and, thus, minimizes the profit of the deal for one party.

C. Conflicts in autonomous bank guarantees and its management

Often, preventive means in respect of avoiding potential risks are not carried out for whatever reason. Subsequently, conflicts arise and have to be resolved. The following section deals with certain situations that occur frequently.

I. The concept of fraud

1. Overview

One of the major issues is the question of fraud. The significance of fraud is based on the fact that, in practice, fraud is in general the only defence available when one seeks to escape from payment under a demand guarantee.¹⁴³ In this section, the thesis focuses

¹⁴⁰ Loke, 'Standby Credits and Performance Bonds: The Lesson of the Iranian Experience' in Chinkin/Davidson/Ricquier, *Current Problems of International Trade Financing*, 283 at 290.

¹⁴¹ See in respect to the higher total costs of several bonds: chapter 2 C II.

¹⁴² Rowe, *Guarantees*, p. 72.

¹⁴³ Rowe, *Guarantees*, p. 87.

on first demand guarantees since allegations of fraud are nearly always made in regard of such guarantees.¹⁴⁴

Although there exist a vast amount of case law and a wide range of legal writing to this topic, fraud as a defence against payment has been pleaded successfully in only a very small minority of cases.¹⁴⁵ The issue of fraud was highly discussed, for example, in respect to the Iranian revolution that caused a massive calling of guarantees, especially those issued by American banks for the account of their American customers. By invoking the fraud exception, the account parties intended to prevent abusive callings of Iranian beneficiaries that they feared as a consequence of the Iranian revolution and the concomitant deterioration of the relations between Iran and the United States. However, the plea of the defences was mostly unsuccessful.¹⁴⁶

It is generally accepted that the issuing bank has to pay whenever the conditions of the bond are satisfied. It is also established that this obligation cannot be absolute.¹⁴⁷ Fraud constitutes the exception to the rule. This has to be borne in mind by evaluating the different interests that are involved in a dispute: 'On the one hand the legitimate claims of the customer (the account party) need to be protected; but on the other hand, the guarantee should not be denied its independent and unconditional nature'.¹⁴⁸

In light of these observations, it arises the question what are the substantive as opposed to the procedural aspects of fraud.

2. Substantive aspects

a. The notion of fraud

¹⁴⁴ Bertrams, *Bank Guarantees in International Trade*, p. 276.

¹⁴⁵ Chong, 'The Abusive Calling of Performance Bonds', *Journal of Business Law* 1990, 414 at 416.

¹⁴⁶ See for details for example: Freiherr von Marschall, 'Recent Developments in the Field of Standby Letters of Credit, Bank Guarantees and Performance Bonds' in Chinkin/Davidson/Ricquier, *Current Problems of International Trade Financing*, 261 at 276 et seq.

¹⁴⁷ Freiherr von Marschall, 'Recent Developments in the Field of Standby Letters of Credit, Bank Guarantees and Performance Bonds' in Chinkin/Davidson/Ricquier, *Current Problems of International Trade Financing*, 261 at 274; Harfield, 'Guaranties, Standby Letters of Credit, and Ugly Ducklings', *Uniform Commercial Code Law Journal* 1994, Vol. 26, 195 at 199, footnote 7.

¹⁴⁸ Von Houtte, *The Law of International Trade*, p. 308.

aa. The definition of fraud

To come straight to the result, there is no unanimous international definition of fraud. Rather, there exists a wide range of different notions and terms of what should be regarded as fraudulent. Terms, which illustrate the variety of examples, are ‘abuse’, ‘bad faith’ and ‘arbitrariness’. The rationale for the various notions is that the notions ‘have been developed along national patterns which may not be suitable for demand guarantees, being a product of **international trade**’.¹⁴⁹

Before the notion of fraud will be described according to international law, a systematic approach is chosen in order to characterize the exception of fraud:

In this respect, the nature and purpose of independent bank guarantees are of major importance. Independent bonds encompass an allocation of risks between the parties to the underlying contract: The beneficiary of a bank guarantee does not encounter the common risks to which it would be exposed without a bank guarantee. Such risks are all kinds of problems that could occur in the course of trying to receive financial compensation for a breach of contract, for example the risk of a defeat in court proceedings.¹⁵⁰ In applying the notion of fraud, the observance of the initial allocation of risks must be a fundamental principle.

Furthermore, it is characteristic for guarantees that the bank’s commitment of paying the beneficiary is in general independent from the underlying contract. The exception to the rule of independence is fraud.¹⁵¹ But, as important guideline, it must be emphasized that fraud should be limited to only exceptional cases. Otherwise, there is the risk that fundamental principles of independent bank guarantees would be undermined¹⁵² and this would harm the popularity of the instrument as security device in international trade. Therefore, only defences that are material and relate to the essence of the underlying contract should be taken into account as examples for fraud.

¹⁴⁹ Bertrams, *Bank Guarantees in International Trade*, p. 276.

¹⁵⁰ See for details: Bertrams, *Bank Guarantees in International Trade*, p. 59 et seq.

¹⁵¹ Bertrams, *Bank Guarantees in International Trade*, p. 276.

After examining crucial features of independent bank guarantees, fraud can be determined in general as *situation in which the beneficiary's call has no conceivable basis under the underlying contract*.¹⁵³

In principle, a fraudulent call can occur in two situations:¹⁵⁴ The beneficiary calls the bond without justification according to the underlying contract. Another way is that the beneficiary forged or submits fraudulent documents in order to obtain payment. The latter is, however, of minor significance and occurs more often in the context of letters of credit because the only document, that could be required in a first demand guarantee, is a written statement by the beneficiary.

Finally, it has to be borne in mind that there is a difference between non-compliance with the bond's terms and fraud as an exception to the bank's payment commitment. In the former event, the account party's objection solely stems from the bond itself and is not based on the underlying contract. To be precise, the bank's payment obligation does not materialize according to the provisions of the guarantee.

The same distinction has to be made in respect to a counter-guarantee in the event of a second bank issuing the bond.

bb. Fraud and evidence

According to the remedial function¹⁵⁵, autonomous bonds provide for an immediate availability of additional financial resources. This essential feature is encapsulated in the principle 'pay first and argue later'.¹⁵⁶ It describes that the bank's payment to the beneficiary is made even if the account party protests because of objections stemming from the underlying contract. Subsequently, the account party has to institute main proceedings against the beneficiary in order to recover its money. In these proceedings, the account party has to prove that the beneficiary was not entitled to call the bond.

¹⁵² See the principles mentioned in chapter 3 C I 1 as well.

¹⁵³ Rowe, *Guarantees*, p. 90; Bertrams, *Bank Guarantees in International Trade*, p. 257; Horn/Wymeersch, *The Law of International Trade Finance*, p. 482..

¹⁵⁴ Chong, 'The Abusive Calling of Performance Bonds', *Journal of Business Law* 1990, 414 at 416 et seq.

¹⁵⁵ See chapter 2 A II.

Regarding the issue of fraud and its evidence in emergency proceedings, it should be inferred that first payment can only be prevented in the event of **unequivocal and immediately produced evidence** of fraud.¹⁵⁷ Only in these circumstances, main proceedings can be avoided.

In the context of bank guarantees, Continental and English law agree that evidence of an actual, as opposed to a constructive fraudulent intent on the part of the beneficiary to inflict harm is not necessary.¹⁵⁸ Thus, the terms 'fraud' and 'abuse' are the same in content and are used synonymously in this thesis.

It is important to emphasize that both the notion of fraud and the required evidence can extremely differ between countries and even within a country between case law and legal writing.¹⁵⁹

b. Diverse manifestations of fraud

Although having found a guiding principle, the notion of fraud is still vague and imprecise. The most significant task is to apply this notion to the facts of a concrete case. In order to shed some more light on the notion of fraud, typical situations in the context of fraud will be examined.

aa. Conditions precedent

The issue of fraud often arises if a condition precedent, designated in the underlying contract, does not occur, but the beneficiary calls the guarantee nevertheless. The beneficiary's call is abusive if it is a condition precedent that is 'truly essential for the

¹⁵⁶ Bannier, 'Bank Guarantees and Documentary Credit', *Hague-Zagreb Essays* 6 1987, 65 at 75.

¹⁵⁷ Affirmative and with a corresponding note to litigation Bertrams, *Bank Guarantees in International Trade*, p. 277.

¹⁵⁸ Bertrams, *Bank Guarantees in International Trade*, p. 273.

¹⁵⁹ See for details in regard to different countries for example: Horn/Wymeersch, *The Law of International Trade Finance*, p. 483 et seq.; O'Driscoll, 'Performance Bonds, Bankers' Guarantees, and the Mareva Injunction', *Northwestern Journal of International Law and Business* 1985, 380 at 381 et seq.

operation of the contract and refers to a material aspect of the contract'¹⁶⁰. The call is fraudulent because the account party is usually not responsible for the non-fulfilment of a condition precedent.

The situation is different if the risk of non-fulfilment is attributed to the account party in terms of the principal contract. Under these circumstances, the beneficiary's call is legitimate and in accordance with the allocation of risks of the underlying contract.

After all, the account party is well advised to protect itself against the attribution of the risk of non-fulfilment of a condition precedent. The easiest way of such an undertaking is to insert a matching condition precedent as prerequisite of a call in the wording of the bond. Without the occurrence of the condition precedent, the beneficiary's claim against the bank does not materialize.¹⁶¹

bb. Completion of the underlying contract

The beneficiary's call of the bond is fraudulent if the account party properly performs its obligations arising from the underlying contract.¹⁶² This proposition is trite and confirmed in case law and legal writing.

However, major problems often occur by proving proper completion. The account party bears the burden of proof. It has to be pointed out that mere allegations, testimony and documentation from the account party are considered insufficient.¹⁶³ The account party must produce documents from independent third parties, especially those nominated by the beneficiary, or documents, statements or acknowledgements from the beneficiary itself in order to reinforce its allegation of an abusive call. As a rule, if the court is satisfied that the beneficiary's complaints are genuine or plausible or have at least some basis, the account party does not reach a finding in its favour. Conversely, if the beneficiary's objections are vague and insignificant, the court probably regards the bond's call as fraudulent.¹⁶⁴

¹⁶⁰ Bertrams, *Bank Guarantees in International Trade*, p. 281.

¹⁶¹ See chapter 3 C I 2 a.

¹⁶² See for example: Beckers, 'Bank policies on guarantee calls', *International Financial Law Review* 10/1982, 32 at 34; Rowe, *Guarantees*, p. 90.

¹⁶³ *United Trading Corporation SA and Murray Clayton Ltd. v. Allied Arab Bank Ltd. and others* (1985)

2 Lloyd's Law Reports 554.

¹⁶⁴ See for example: LG Frankfurt am Main, *Neue Juristische Wochenschrift* 1981, p. 56.

It is noteworthy that the lapse of the contractual warranty period does not simultaneously mean that the account party has properly fulfilled its contractual obligations.¹⁶⁵ The expiry of the warranty period only has the legal consequence that the beneficiary is not entitled any longer to hold the account party liable under the contract for any defects. Accordingly, even if the beneficiary does not lodge any complaints within the warranty period, the account party is nevertheless obliged to prove completion of its obligations.

cc. Violation of the beneficiary's own obligation

The beneficiary's demand for payment under the bond is fraudulent if the beneficiary breached the contract too. An abusive call can be based on a previous undertaking of the beneficiary according to which the account party's performance is rendered impossible or which is the only reason for a delay in performance. If the beneficiary, for example, destroys the contractual object and the account party cannot carry out its contractual work on that object, a subsequent demand for payment will be fraudulent. Such circumstances can be categorized as physical impossibility.

In addition, if the beneficiary's action causes impossibility of the performance or its delay in any other way, a call of the bond is not warranted.¹⁶⁶ A fraudulent demand for payment is given, for example, if the beneficiary previously fails to provide the necessary documents required for shipment of the goods despite repeated requests from the account party.¹⁶⁷ However, the account party must produce clear evidence that it has fulfilled all its obligations and that non-performance is solely caused by the beneficiary's acts or omissions.

However, the underlying principle is that the beneficiary's own breach must be much more serious and fundamental than this of the account party. To be precise, 'the beneficiary's breach of contract must be such as to entitle the account party immediately to rescind the contract without incurring any liability'¹⁶⁸. Only in these exceptional circumstances, there is no conceivable basis for a call under the guarantee

¹⁶⁵ Bertrams, *Bank Guarantees in International Trade*, p. 286.

¹⁶⁶ Bertrams, *Bank Guarantees in International Trade*, p. 290.

¹⁶⁷ Ghent, February 25 1988, *Tijdschrift Belgisch Handelsrecht* 1989, p. 40.

and, consequently, the call is fraudulent.¹⁶⁹ For example, if the beneficiary fails to provide a letter of credit in favour of the account party, although it is obliged to do so according to the provisions of the principal contract, it is submitted that a subsequent call of the bond should be considered fraudulent.¹⁷⁰

dd. *Force majeure*

The account party, raising *force majeure* as defence of non-performance, faces certain problems.

It must be repeated that the bank usually has to honour the beneficiary's demand for payment according to the terms and conditions of the bond. Exceptions to this rule must be restricted.

Bearing this in mind, the account party must prove that the supervening events occurred and that these incidents have rendered performance impossible. The latter includes the proof that there have been no other adequate means of performance that the account party has been able to resort. Even a modification of the manner of performance must be contemplated and even if more costs are involved, a variation can be reasonable in order to achieve the object of the contract. Furthermore, it is noteworthy that temporary events do not render the performance completely impossible.

Besides impossibility of performance, Bertrams points out, that 'the general law on *force majeure* poses other requirements too, such as evidence that the supervening events had not been contemplated by the parties to the contract, that they were beyond the control of the debtor and that they exceeded the range of risks which are to be attributed to the debtor'.¹⁷¹ By taking into account the variety of obstacles, it is doubtful if the account party can establish fraud based on *force majeure* in other than full-length main proceedings.

¹⁶⁸ Bertrams, *Bank Guarantees in International Trade*, p. 288.

¹⁶⁹ See chapter 3 C I 2 a.

¹⁷⁰ Trib. Com. Paris, December 14 1990, *Recueil Dalloz Sirey* 1991 Somm. p. 201. However, there are some dissenting opinions in respect of this issue-see for details: Bertrams, *Bank Guarantees in International Trade*, p. 290, footnote 37.

¹⁷¹ Bertrams, *Bank Guarantees in International Trade*, p. 293.

The account party cannot raise the defence of *force majeure* in order to prevent payment under an advance payment bond. The object of an advance payment guarantee is broader than that of a performance guarantee.¹⁷² The former functions as security for repayment in the case of non-performance. If the beneficiary's call of the guarantee was regarded as fraudulent because of *force majeure*, it would not get back its down payment. Thus, the beneficiary would be unfairly burdened with the consequences of *force majeure*. This allocation of risk would be in contradiction to the object of a repayment guarantee.

ee. Set-off

The issue of fraud also arises if the account party has a clear, liquid and indisputable counterclaim against the beneficiary **stemming from the same principal contract**. It could be argued that under the mentioned circumstances the account party can set its counterclaim off against the beneficiary's claim.¹⁷³ Accordingly, a subsequent call on the guarantee would be (entirely or partially) abusive. On the other hand, it is submitted that a set-off is not permitted and, therefore, the bank has to honour the beneficiary's demand for payment.¹⁷⁴ This view contends that the account party cannot resort to set-off as means to enforce its own claim. Otherwise, this undertaking would amount to a security for payment and a security device has exactly not been issued.

The latter point of view is preferable because it considers the agreed allocation of risks between the account party and the beneficiary. The guarantee has been issued to be of the sole benefit to the beneficiary and to make additional financial resources available if the risk, covered by the guarantee, is realized. This liquidity function cannot be achieved in a situation of set-off. Hence, the beneficiary must receive payment even if the account party is the creditor of a counterclaim against the beneficiary. The account party, on the other hand, has to enforce its claim in a separate procedure.

3. Procedural aspects

¹⁷² See chapter 2 C III.

¹⁷³ Trib. Com. Brussels, April 15 1991, Recueil Dalloz Sirey 1992 Somm. p. 242; Von Westphalen, Die Bankgarantie im internationalen Handelsverkehr, p. 397.

Before examining the respective legal relationships of the involved parties, it is necessary to observe essential procedural aspects adhering independent bank guarantees. If the account party is of the opinion that the beneficiary's demand is fraudulent, it may take recourse to courts. It is important to reach a speedy decision, since the bank's payment will be effected otherwise. Hence, main proceedings should not be instituted. Usually, proceedings known as provisional, interim, preliminary or interlocutory proceedings are contemplated. Within these court procedures, the account party can apply for an injunction against the bank restraining it from making payment and/or against the beneficiary restraining it from calling the guarantee. (The latter applies in respect to a second bank as well which could call a counter-guarantee.) In this thesis, such an injunction is called restraining order.¹⁷⁵

Another possibility of preventing payment is to apply for a Continental conservatory attachment under the bank or the English equivalent, that is a Mareva injunction. Both instruments, as O'Driscoll explains, intend 'to freeze a defendant's assets prior to judgement in order to prevent the removal of those assets from the jurisdiction of the court'.¹⁷⁶ The conservatory attachment and the Mareva injunction respectively, however, are seldom utilized to intervene in the normal course of bank guarantees.¹⁷⁷ In practice, restraining orders are usually preferred and, thus, are focused on in this thesis. This development is based on several reasons: The scope of conservatory attachments and Mareva injunctions respectively are sometimes equivocal and often very much restricted according to the different national codes of procedure.¹⁷⁸ In addition, if the account party applies for a conservatory attachment, the bank can pay the amount of money concerned in a blocked account and can debit its customer's account anyway.¹⁷⁹

¹⁷⁴ Bertrams, *Bank Guarantees in International Trade*, p. 299.

¹⁷⁵ Other terms, frequently used, are application for restraining or stop-payment order. See for example: Von Houtte, *The Law of International Trade*, p. 308 and Bertrams, *Bank Guarantees in International Trade*, p. 258.

¹⁷⁶ O'Driscoll, 'Performance Bonds, Bankers' Guarantees, and the Mareva Injunction', *Northwestern Journal of International Law and Business* 1985, 380 at 398; *Mareva Compania Naviera S.A. v. International Bulkcarriers S.A.* (1975) 2 *Lloyd's Law Reports* 509.

¹⁷⁷ Bannier, 'Bank Guarantees and Documentary Credit', *Hague-Zagreb Essays* 6 1987, 65 at 86; Rubino-Sammartano, 'Performance Bonds: Primary or Secondary Obligations?', *International Business Lawyer* 03/1985, 125 at 126.

¹⁷⁸ Rowe, *Guarantees*, p. 88; Bertrams, *Bank Guarantees in International Trade*, p. 335 et seq.; Bannier, 'Bank Guarantees and Documentary Credit', *Hague-Zagreb Essays* 6 1987, 65 at 86 et seq.

¹⁷⁹ Bertrams, *Bank Guarantees in International Trade*, p. 341.

In order to avoid the debiting of its account, it is advisable for the account party to apply for a restraining order, where it is appropriate.

If the account party does not raise the defence of fraud before payment is effected, the defence can be invoked in proceedings after payment has taken place. In these proceedings, the account party refuses to reimburse the bank or attempts to undo the debiting of its account because the bank violated its contractual obligations towards the account party.¹⁸⁰

In only few cases, banks invoke the defence of fraud vis-à-vis the beneficiary in order to refuse its demand for payment. This procedure occurs only rarely because banks do not want to harm their international reputation.¹⁸¹

This scenario mainly takes place in the event of the account party's insolvency, where the bank runs the risk of receiving no reimbursement for the payment to the beneficiary.¹⁸²

II. Relationships of the parties

In light of considerable amounts of money being at stake, disputes often arise in the context of bank guarantees, especially with respect to the proper trigger of the payment mechanism. This section examines specific aspects of conflicts between the parties and, in particular, the issue of fraud.

After reaching no agreement in disputes, parties take recourse to courts. In order to evaluate the chance of being successful in court proceedings, it is necessary to analyse the surrounding relationships of independent bank guarantees.

1. Account party and instructing/correspondent bank¹⁸³

a. Strategy of several defendants

¹⁸⁰ See chapter 3 C II 1 c aa.

¹⁸¹ See chapter 3 B II 1.

¹⁸² Bertrams, *Bank Guarantees in International Trade*, p. 258.

If the account party intends to institute proceedings, it faces the issue whom to sue or against whom applications for restraining orders are to be brought. In both direct and indirect guarantees, the account party is well advised to sue/bring applications against all participants in the guarantee.¹⁸⁴ Courts are possibly more inclined to judge in favour of the account party if all parties and their corresponding interests can be heard in the proceedings. This is in particular the case if one of the defendants decides not to appear during the proceedings or its arguments lack any substance.

Furthermore, even if the bank is the sole defendant, the proceedings will focus on the commitment of fraud anyway and, therefore, on the behaviour of the beneficiary.

Conversely, if a judgement against the bank is granted, it can maintain its neutral position vis-à-vis the beneficiary if payment is demanded and can refer to this judgement.

b. The doctrine of compliance

While applications for restraining orders are usually made in the context of first demand bonds and fraud, it also happens that applications are made by arguing that the terms of the guarantee have not been met. The background for such an injunction is that the bank owes a duty to its customer according to which it has to ascertain whether the beneficiary's demand for payment complies with the conditions of the guarantee.¹⁸⁵ If the demand does not satisfy the conditions of the guarantee, the bank has to refuse payment.¹⁸⁶ To be precise, the bank has, for example, to ascertain whether the call has been made in the correct form and by the proper person and whether the beneficiary has submitted all required documents. The bank's duty is confined to examine only formal compliance with the conditions of the bond, that is whether the documents, for example, correspond on its face with the stipulated documents in the guarantee.¹⁸⁷ If the beneficiary, however, submits several documents, the bank has to ensure that there is no contradiction to the respective documents.

¹⁸³ See for details of the respective relationship: chapter 2 B III.

¹⁸⁴ Rowe, *Guarantees*, p. 88; Bertrams, *Bank Guarantees in International Trade*, p. 321 et seq.

¹⁸⁵ Bertrams, *Bank Guarantees in International Trade*, p. 112.

¹⁸⁶ This principle corresponds with the bank's duty in the case of a traditional letter of credit.

¹⁸⁷ Bannier, 'Bank Guarantees and Documentary Credit', *Hague-Zagreb Essays* 6 1987, 65 at 80.

Besides formal compliance, the demand for payment has to comply strictly with the conditions of the guarantee.¹⁸⁸ Otherwise, courts will grant preventive restraining orders or the bank will be liable if it is later ascertained that the conditions of the guarantee have not been strictly observed. The principle of strict compliance serves to safeguard the position of the account party. It is the account party that specifies the conditions according to which the payment mechanism is precisely triggered. In addition, the bank is protected as well because it does not need to evaluate the conflicting interests in the event of other than the required documents.¹⁸⁹

The principles of formal and strict compliance also apply to the first bank in relation to the second bank's demand for payment on the basis of the counter-guarantee.

c. Fraud and knowledge¹⁹⁰

aa. Direct guarantee

In respect of court proceedings dealing with fraud, Bertrams points out, that 'if fraud by the beneficiary is evident to the bank, it owes a duty to the account party to refrain from payment'.¹⁹¹ It is important to emphasize that the bank is not obliged to inquire into a possibly fraudulent demand for payment because it is not concerned with the underlying contract (doctrine of independence).¹⁹² Moreover, a mere allegation of fraud by the account party is not sufficient evidence of an abusive call.¹⁹³

¹⁸⁸ Von Houtte, *The Law of International Trade*, p. 306.

¹⁸⁹ On the other hand, it has to be pointed out that the application of the named doctrine should not generate unreasonable or absurd results. For further details: Bertrams, *Bank Guarantees in International Trade*, p. 115 and in footnote 59.

¹⁹⁰ In this section, it is presumed that the (correspondent) bank pays the beneficiary at first and *subsequently* tries to achieve settlement from the account party (instructing bank).

¹⁹¹ Bertrams, *Bank Guarantees in International Trade*, p. 305.

¹⁹² Oberlandesgericht Schleswig, December 6 1983, *Wertpapier-Mitteilungen* 1984, p. 651; Von Westphalen, *Die Bankgarantie im internationalen Handelsverkehr*, p. 196 et seq., 247 et seq.

¹⁹³ Freiherr von Marschall, 'Recent Developments in the Field of Standby Letters of Credit, Bank Guarantees and Performance Bonds' in Chinkin/Davidson/Ricquier, *Current Problems of International Trade Financing*, 261 at 275.

However, the bank's duty to refrain from payment stems from the contract of mandate concluded with the account party. According to the ancillary duty of the contract, the bank has to act in good faith and due care vis-à-vis its contracting partner.

It is decisive that the bank has knowledge of the abuse **at the time of payment**.¹⁹⁴ The bank's knowledge of fraud derives from the facts of the respective case. In *United Trading Corporation SA and Murray Clayton Ltd. v. Allied Arab Bank Ltd. and others* the Court of Appeal held that knowledge is presumed 'where the only realistic inference to be drawn from the evidence is that the beneficiary calls on the bond fraudulently (...)'.¹⁹⁵

bb. Indirect guarantee

In an indirect guarantee, the correspondent bank is in the same way obliged as the bank in a direct guarantee. Thus, if the beneficiary's fraud is evident to the correspondent bank, it has to refuse payment. This obligation is based on a general duty of care that is owed towards the account party and does not arise from a contractual relationship.¹⁹⁶

The account party faces a problematic scenario if it applies for an injunction against the instructing bank restraining it from effecting payment to the correspondent bank because of fraud: Firstly, the account party has to establish the abusive demand of the beneficiary. Secondly, the correspondent bank's awareness of that abuse at the time of payment must be established.¹⁹⁷ Thirdly, the account party must persuade the court that the correspondent bank called the counter-guarantee of the instructing bank fraudulently and that the latter has knowledge thereof.¹⁹⁸ This is almost an impossible undertaking for the account party and is rarely successful.

¹⁹⁴ *United Trading Corporation SA and Murray Clayton Ltd. v. Allied Arab Bank Ltd. and others* (1985) 2 Lloyd's Law Reports 554 at 560; Chong, 'The Abusive Calling of Performance Bonds', *Journal of Business Law* 1990, 414 at 418.

¹⁹⁵ *United Trading Corporation SA and Murray Clayton Ltd. v. Allied Arab Bank Ltd. and others* (1985) 2 Lloyd's Law Reports 554.

¹⁹⁶ See chapter 2 B III 3; Bertrams, *Bank Guarantees in International Trade*, p. 309 et seq.

¹⁹⁷ See for example: CA Amsterdam, February 4 1993, Kort Geding 1993, 113; CA Leeuwarden, September 12 1990, Kort Geding 1990, 316; Landgericht Stuttgart, August 8 1980, Wertpapier-Mitteilungen 1981, p. 633.

¹⁹⁸ Penn/Shea/Arora, *The Law and Practice of International Banking*, p. 279.

If the account party applies for an injunction against the correspondent bank in order to restrain it from calling the counter-guarantee, corresponding principles apply: The account party has to establish the beneficiary's abusive call and the knowledge thereof of the correspondent bank at the time of payment.

2. Account party and beneficiary

An application for an injunction against the beneficiary for restraining it from demanding or receiving payment under the bond is governed by the same principles that apply to the relationship of the account party and the bank.¹⁹⁹

Nevertheless, it seems easier to reach an injunction against the beneficiary than against the bank. The rationale is that other aspects in this relationship predominate: The position of the bank might not need to be considered and the principle of independence does not play such an important role as in relation to the bank.

3. Instructing bank and correspondent bank

The relationship between the instructing and the correspondent bank is characterized by a special feature: The effect of a restraining order against the correspondent bank is often limited because of the inter-bank relationship.

This inter-bank relationship exists where the banks work together on a regular basis and maintain a current account with one another. Under these circumstances, the correspondent bank cannot be stopped by a restraining order from debiting the common account for the amount that has been paid to the beneficiary.²⁰⁰

¹⁹⁹ *Deutsche Rückversicherung AG v. Walbrook Insurance Co.* (1994) 4 All England Law Reports, 181 at 196 et seq.

²⁰⁰ Bertrams, *Bank Guarantees in International Trade*, p. 331.

If the instructing bank allocates this risk to the account party according to the provisions of the contract of mandate, it can take recourse against its customer and no restraining order is capable of stopping the instructing bank in doing so.²⁰¹

CHAPTER 4 – JURISDICTION, APPLICABLE LAW AND UNIFORM RULES

A. Jurisdiction

I. General aspects

The issue of jurisdiction is usually governed by the law of the forum.

An exception is given in cases of international conventions which have priority. The 1968 European Economic Community (Brussels) Convention on Jurisdiction and the Enforcement of Judgements in Civil and Commercial Matters, as amended, is one of these international conventions. This convention is especially important if the defendant is resident in one of the member states to the convention.²⁰² According to this convention, however, domestic law of a member state applies to the determination of jurisdiction in cases of restraining orders in provisional proceedings.²⁰³

It is noteworthy that a jurisdiction or arbitration clause in the principal contract does not refer to matters concerning the contract of guarantee between the bank and the beneficiary, but governs only the relationship of the parties to the underlying contract.²⁰⁴

The legal situation is similar if the counter-guarantee between the instructing and correspondent bank includes a clause that provides for exclusive jurisdiction in the foreign correspondent bank's country. The account party is not a party to that contract and, therefore, is not bound by the provision. For example, the account party can institute proceedings in its country against the correspondent bank as co-defendant.

²⁰¹ Landgericht Düsseldorf, August 9 1984, *Recht der Internationalen Wirtschaft* 1985, p. 77.

²⁰² Art. 2 EEC Convention.

²⁰³ Art. 24 EEC Convention.

II. Relationships of the parties

In the event of proceedings initiated by the account party in a direct guarantee, proceedings against the bank will nearly always take place in the forum of the account party's country. This is the factual situation because it is usually the place where the bank is situated too.

If the account party also applies for an injunction in these proceedings against a foreign beneficiary as co-defendant, Bertrams emphasizes that 'courts have never declined jurisdiction' over such defendants.²⁰⁵

In an indirect guarantee, the account party has been advised in this thesis to apply for restraining orders against all parties involved.²⁰⁶ In accordance with this advice, courts accept jurisdiction over foreign correspondent banks and foreign beneficiaries (jurisdiction *ratione personae*).²⁰⁷

However, it is doubtful if courts in the account party's country have jurisdiction *ratione materiae* in respect of an order against the foreign correspondent bank restraining it from paying under the bond and/or an order against the foreign beneficiary restraining it from demanding and receiving payment.²⁰⁸ The doubts exist in this issue because the orders are intended to take effect only in a foreign country.

Nevertheless, international case law reveals that this dispute is academic because it has widely been disregarded in practice.²⁰⁹ Since this thesis mainly focuses on aspects of international business practice, the dispute is outside the scope of this paper.

In practice, the mentioned restraining orders are granted against foreign banks and beneficiaries and, thus, it is useful to bring applications for orders against all parties of a bank guarantee.

²⁰⁴ See chapter 3 B II 2; Rowe, *Guarantees*, p. 60.

²⁰⁵ Jurisdiction can be based on the presence of assets (guarantee funds), the place where the order takes effect or multiple defendants. See for details: Bertrams, *Bank Guarantees in International Trade*, p. 346.

²⁰⁶ See chapter 3 C II 1 a.

²⁰⁷ See footnote 205.

²⁰⁸ Bertrams, *Bank Guarantees in International Trade*, p. 328 et seq. Another difficulty is mentioned there, namely whether granted judgements would be recognised in the foreign country.

²⁰⁹ Trib. Com. Brussels, May 26 1988, *Journal des Tribunaux* 1988, p. 460; Cass., June 10 1986, *Recueil Dalloz Sirey* 1987 J., p. 17; Trib. Com. Paris, August 1 1984, *Recueil Dalloz Sirey* 1984 I.R., p. 159.

If the beneficiary institutes proceedings against the bank or, in an indirect guarantee, the correspondent bank against the instructing bank, the proper forum will usually be situated in the (instructing) bank's domicile.²¹⁰ For ensuring proceedings in its own country, a beneficiary is well advised to insist on the issuance of an indirect guarantee. Thus, the beneficiary and the correspondent bank are usually domiciled in the same country where the beneficiary can initiate proceedings.

B. Applicable law

I. General aspects

The significance of private international law as technique for selecting the applicable law is contentious:

Some authors are of the opinion that private international law is of little significance for independent bank guarantees.²¹¹ In contrast to this view, others contend that private international law plays a decisive and important role in this context.²¹²

The intermediate approach should be taken:

It is to ascertain that case law only rarely refers to the issue of the applicable law.²¹³ Furthermore, if a court deals with the matter, it often states the application of a foreign law but then proceeds to apply the notions prevailing in the court's own jurisdiction. Although, as Bertrams points out, 'the attitude and the perceptions of courts, when evidently applying their own notions, can by no means be described as provincial'.²¹⁴ On the other hand, the significance of private international law should not be underestimated, especially in light of the involvement of several parties and their frequent transnational relationships. In addition, it cannot be denied that private international law has to be considered in regard to certain matters: Interest and damages

²¹⁰ This is in accordance with art. 28 Uniform Rules for Demand Guarantees..

²¹¹ Von Houtte, *The Law of International Trade*, p. 305; Bertrams, *Bank Guarantees in International Trade*, p. 347.

²¹² Penn/Shea/Arora, *The Law and Practice of International Banking*, p. 274.

²¹³ See for details: Bertrams, *Bank Guarantees in International Trade*, p. 347.

²¹⁴ Bertrams, *Bank Guarantees in International Trade*, p. 347.

in the event of late payment, requirements of a formal notice of default, formation of the contract of guarantee and, for example, the limitation of actions.²¹⁵

In order to determine the applicable law of an international contract, courts primarily pay attention to an express choice of law.

In addition, Bennett explains 'If a contract has no express choice of law, and if a thoroughly subjective approach to the proper law is adopted, a court seeking to discover the applicable law may be obliged to read an implied term into the contract purporting to represent the parties' common intent'.²¹⁶

Failing an express or an implied choice of law, the proper law of a contract is the law of the country to which the contract is most closely connected. One of the issues that has been considered insofar is where the party, that has to effect the characteristic performance of the contract, has its place of business.

II. Transnational relationships of the parties

The relationship of the account party and the (instructing) bank is usually governed by the law of the bank's place of business if the parties have their place of business in different countries. This is based either on a choice of law clause or the feature of the characteristic performance, that is the issuance of the guarantee and payment to the beneficiary or the instruction to issue a bond.

In transnational relationships between beneficiary and (correspondent) bank, the law at the latter's place of business is decisive for the same reasons as in relation to account party and (instructing) bank.

A more difficult task is the determination of the applicable law in the international relationship of the instructing and the correspondent bank:

²¹⁵ Horn, 'The United Nations Convention On Independent Guarantees and the Lex Mercatoria', <http://www.cnr.it/CRDCS/horne.htm>.

²¹⁶ Bennett, 'The law applicable to international transactions', Materials to the course 'The Law of International Trade', p. 11.

Some authors suggest that the relationship should be governed by the law of the country where the instructing bank has its place of business if a choice of law clause does not exist.²¹⁷ This approach is in accordance with the uniform rules of the 1995 United Nations Convention on Independent Guarantees and Standby-Letters of Credit (Uncitral Convention) and the 1991 Uniform Rules for Demand Guarantees (URDG).²¹⁸

A different view contends that the law of the correspondent bank's country would govern the inter-bank relationship.²¹⁹ The latter view is preferable because it corresponds with the systematic approach for selecting the applicable law.²²⁰ If there is no express or implied choice of law, the law is applicable to which the contract is most closely connected. The closest connection exists to the law of the correspondent bank's country because this bank performs the characteristic obligation of the contract, that is the issuance of the guarantee in favour of the beneficiary and the execution of the guarantee. The instructing bank is merely obliged to pay charges and to indemnify the correspondent bank.

Moreover, the selected point of view is advantageous because the contractual relationship between the beneficiary and correspondent bank and the inter-bank relationship are governed by the same set of rules. This avoids possible conflicts of the correspondent bank which could otherwise arise owing to different applicable rules in the relationships.

C. Uniform rules

I. Overview

Since the beginning of the 1970s, a steady increase in the use of bonds has been ascertained.²²¹ Transnational practice generated widely used principles with respect to

²¹⁷ Rowe, *Guarantees*, p. 86; Von Houtte, *The Law of International Trade*, p. 305.

²¹⁸ Art. 21, 22 Uncitral Convention and art. 27 URDG.

²¹⁹ Bannier, 'Bank Guarantees and Documentary Credit', *Hague-Zagreb Essays* 6 1987, 65 at 68; Von Houtte, *The Law of International Trade*, p. 71; Bertrams, *Bank Guarantees in International Trade*, p. 351 and others mentioned in footnote 25.

²²⁰ See chapter 4 B I.

²²¹ See chapter 2 A I.

meaning and legal effects of bank guarantees, especially in regard to the principle of independence.

Moreover, the international community mostly faced the same legal problems that arose in the context of bonds. In particular, the issue of unfair calling is a widespread problem throughout the world. In order to encounter these problems and to harmonize the use on an international level, a number of attempts have been made to codify the law of international guarantees. It is important to consider the significant steps in that development, so that, finally, an apt evaluation of the 1995 Uncitral Convention can be made.

II. Different approaches of uniform rules

1. Uniform Rules for Contract Guarantees

In 1978, the International Chamber of Commerce (ICC) issued Uniform Rules for Contract Guarantees (URCG).²²² These rules convey excellent protection in favour of the account party against abusive calling. This goal is achieved by making the beneficiary's claim contingent upon proof of the occurrence of the risk covered by the guarantee. This proof is to be produced through a court decision, an arbitral award or a declaration of the account party.²²³ Thus, the so-called 'contract guarantees' are accessory to the underlying contract.²²⁴

On the subject of first demand guarantees, the URCG make no provision, since 'the rules do not encourage the use of such guarantees and are not drafted to apply thereto'.²²⁵ It is obvious that beneficiaries and banks are not very keen on dealing with such bonds: Beneficiaries, who request bonds, do generally not like to carry out the described procedure before receiving money. Banks, on the other hand, do not wish to get involved in disputes concerning the underlying contract. Accordingly, the rules

²²² ICC Publication no. 325, 1978.

²²³ Art. 9 URCG.

²²⁴ Horn/Wymeersch, *The Law of International Trade Finance*, p. 465.

²²⁵ Introduction to ICC Rules 1978.

could not gain general recognition and have been used only rarely.²²⁶ In addition, it is submitted that 'another factor which contributed to their ill fate is that the URCG are rather general, imprecise, fragmentary and conceptually fragile.'²²⁷

2. Uniform Rules for Demand Guarantees

In 1991, the ICC issued a new set of rules, namely the URDG.²²⁸ These rules balance the conflicting interests more reasonable than the uniform rules of 1978.²²⁹ The rules correspond with international business practice and deal with the popular demand bond.

In particular, it should be emphasized that the beneficiary does not have to procure evidence for the account party's breach of contract before calling the guarantee. Rather, a written declaration of the beneficiary is sufficient to trigger the payment mechanism. This unilateral statement, however, must encompass certain facts, namely the circumstances of the alleged breach of contract of the account party.²³⁰ Such a declaration aims to reduce the risk of an unfair calling: A beneficiary who is not justified to call the bond might hesitate before committing himself to an intentionally false and written statement of breach.²³¹

Another significant point is that the bank has to inform the account party if the beneficiary demands payment. Moreover, the bank must furnish the written demand and any additional documents of the beneficiary to the account party.²³² This enables the account party to resort to countermeasures against an abusive call at an early stage and, thus, conveys protection.²³³

²²⁶ Von Houtte, *The Law of International Trade*, p. 303; Loke, 'Standby Credits and Performance Bonds: The Lesson of the Iranian Experience' in Chinkin/Davidson/Ricquier, *Current Problems of International Trade Financing*, 283 at 293.

²²⁷ Bertrams, *Bank Guarantees in International Trade*, p. 22.

²²⁸ ICC Publication no. 458, 1991 (published in 1992).

²²⁹ See for details: Goode, 'The new I.C.C. Uniform Rules for Demand Guarantees', *Lloyd's Maritime and Commercial Law Quarterly* 1992, 190 at 195, 206.

²³⁰ Art. 20 URDG.

²³¹ Horn, 'The United Nations Convention On Independent Guarantees and the *Lex Mercatoria*', <http://www.cnr.it/CRDCS/horne.htm>; Goode, *Guide to the ICC Uniform Rules for Demand Guarantees*, p. 93.

²³² Art. 21 URDG and see the explanations for the legal situation without the URDG in Chapter 3 B I 2.

The URDG are praised as ‘a clear, concise and well-balanced set of rules which by its very existence gives guidance to all parties concerned to what they may expect and how to act’.²³⁴ However, the international business practice is reluctant to adopt these rules.²³⁵ This is probably based on the fact that banks usually issue **simple** demand guarantees. These guarantees do not require a written statement of facts about the account party’s breach of contract in order to trigger the payment mechanism. Another reason for the rare adoption is that, according to banks, neither beneficiaries nor account parties ask for the incorporation of the rules.

3. Uniform Customs and Practices for Documentary Credits

The 1993 version of the Uniform Customs and Practices for Documentary Credits (UCP) encompasses the significant instrument of standby letters of credit.²³⁶ Art. 1 UCP provides that these articles apply to documentary credits, including, to the extent to which they may be applicable, standby letters of credit.

It is questionable to what extent the UCP is in fact applicable to standby letters of credit and where are the differences between standby letters of credit and traditional letters of credit.

The instruments considerably differ in the following aspects:

The documents of a traditional letter of credit mostly produce evidence and are often issued by third parties.²³⁷ For example in the frequent case of a bill of lading, evidence is produced that the goods have been shipped and the bill of lading is issued by the carrier.²³⁸ Conversely, documents of a standby letter of credit usually contain only non-evidenced statements and are regularly issued by the beneficiary.

²³³ Pierce, *Demand Guarantees in International Trade*, p. 59 et seq.

²³⁴ Bertrams, *Bank Guarantees in International Trade*, p. 23.

²³⁵ Bertrams, *Bank Guarantees in International Trade*, p. 23.

²³⁶ ICC Publication no. 500, 1993 edition.

²³⁷ Horn, ‘The United Nations Convention On Independent Guarantees and the Lex Mercatoria’, <http://www.cnr.it/CRDCS/home.htm>.

²³⁸ Hare, *Shipping Law & Admiralty Jurisdiction in South Africa*, p. 444.

Furthermore, documents of a traditional letter of credit often have an economic value.²³⁹ For example, a bill of lading constitutes the right to possession of the goods.²⁴⁰ The documents of a standby letter of credit, on the other hand, do not have such an economic value. It is usually only a written declaration that the risk, covered by the instrument, has occurred. In the event of a fraudulent call, the document is no more than a written lie by the beneficiary.

In addition, it has been mentioned in this thesis that standby letters of credit rather serve the same purpose and operate in the same way as independent bank guarantees.²⁴¹ Accordingly, Bertrams points out that 'in fact, the larger part of the UCP (...) does not apply to standby letters of credit'.²⁴²

Thus, even if the UCP formally includes standby letters of credit, the major part of the rules is unfortunately not applicable to this important security device because of the considerable differences between standby letters of credit and traditional letters of credit. The rationale for the inclusion is, according to Bertrams, the fact that a suitable uniform set of rules other than the UCP did not exist by the revision of the 1983 version.^{243 244}

4. United Nations Convention on Independent Guarantees and Standby Letters of Credit

On the way to an international set of rules, the United Nations Commission on International Trade (UNCITRAL) prepared the Uncitral Convention that was adopted by the General Assembly of the United Nations. in December 1995.

This thesis does not discuss the Uncitral Convention in all its details. Rather, this section focuses on the Convention's main features and improvements in regard to the preceding attempts of reaching appropriate uniform rules.

²³⁹ Horn, 'The United Nations Convention On Independent Guarantees and the Lex Mercatoria', <http://www.cnr.it/CRDCS/horne.htm>.

²⁴⁰ Hare, *Shipping Law & Admiralty Jurisdiction in South Africa*, p. 550.

²⁴¹ See chapter 2 B 4 IV.

²⁴² Bertrams, *Bank Guarantees in International Trade*, p. 26.

²⁴³ Bertrams, *Bank Guarantees in International Trade*, p. 25.

²⁴⁴ In the meantime, the ICC designed the *International Standby Practices 98*.

The Uncitral Convention by using the terms ‘independent undertaking’ considers that bank guarantees and standby letters of credit are equally utilized in international business practice.²⁴⁵ Both security devices are covered in the Convention.

By explaining the concept of independence,²⁴⁶ it is made clear that conditional payment claims within the scope of the Convention can only be based on conditions that are of a documentary nature.²⁴⁷ Accordingly, the Convention excludes any accessory guarantee from its scope of application which requires more than the mere examination of a documentary demand for payment.²⁴⁸ This approach particularly corresponds with the interests of banks and gives hope for a greater acceptance of the Convention in international business practice.

In contrast to the URDG, the demand for payment must only state a minimum of information, that is the identification of the secured contract.²⁴⁹ This requirement facilitates the procedure of triggering the payment mechanism and avoids delays caused by the examination of detailed documents.

The Convention provides a comprehensive framework for defences against payment and, thus, adequately balances the conflicting interests. The guarantor, for example, has the right to refuse payment if any document has been falsified or payment is not due under the guarantee.²⁵⁰ With respect to the latter, the Convention fixes an expiry date of six years for guarantees in general.²⁵¹

In addition to the possibility of a set-off,²⁵² the Convention for the first time encompasses a codification of the various situations where fraud is present. The relevant provision explains the exception of fraud in general with the wording that

²⁴⁵ Art. 2 (1) Uncitral Convention.

²⁴⁶ Art. 3 Uncitral Convention.

²⁴⁷ In respect to exceptions to the principle: Horn, ‘The United Nations Convention On Independent Guarantees and the Lex Mercatoria’, <http://www.cnr.it/CRDCS/horne.htm>.

²⁴⁸ UNCITRAL, ‘Explanatory note by the UNCITRAL secretariat on the Uncitral Convention’, <http://www.uncitral.org/english/texts/payments/guarant.htm>.

²⁴⁹ Horn, ‘The United Nations Convention On Independent Guarantees and the Lex Mercatoria’, <http://www.cnr.it/CRDCS/horne.htm>.

²⁵⁰ Art. 19 (1a, b) Uncitral Convention.

²⁵¹ Art. 12 (c) Uncitral Convention.

²⁵² Art. 18 Uncitral Convention.

'judging by the type and purpose of the undertaking, the demand has no conceivable basis'.²⁵³ In order to be more precise, the general rule is specifically described by five examples of abuse.²⁵⁴

The first codification of fraud is a significant step to solve crucial problems that occur in international business practice today. The Convention, thus, makes a considerable contribution to the harmonization of the law of bank guarantees and standby letters of credit. Horn, in this respect, adds the Convention 'lays down rules that are today widely recognized in the international community as the basic legal principles of guarantees and standby letters'.²⁵⁵

Finally, it is noteworthy that the Convention already entered into force in five states (Ecuador, El Salvador, Kuwait, Panama and Tunisia) on January 01, 2000. The United States and Belarus have signed the Convention.²⁵⁶ Irrespective of its official recognition as law, contracting parties can refer and incorporate the provisions of the Convention as general conditions of contract.

However, it is more significant that the Convention is a document of the *communis legis opinio* of the international community which can serve as guideline in the international interpretation and application of bank guarantees and standby letters of credit.²⁵⁷

CHAPTER 5 – CONCLUSION

By taking a retrospective look at independent bank guarantees in international trade, it is revealed that the technique of independent bank guarantees is very much characterized by its transnational nature.²⁵⁸ The trend goes away from domestic concepts and rules.

²⁵³ Art. 19 (1c) Uncitral Convention.

²⁵⁴ Art. 19 (2) Uncitral Convention.

²⁵⁵ Horn, 'The United Nations Convention On Independent Guarantees and the Lex Mercatoria', <http://www.cnr.it/CRDCS/home.htm>.

²⁵⁶ Uncitral, Status of Conventions and Model Laws, <http://www.uncitral.org/english/status/status-e.htm>.

²⁵⁷ Horn, 'The United Nations Convention On Independent Guarantees and the Lex Mercatoria', <http://www.cnr.it/CRDCS/home.htm>.

²⁵⁸ Von Houtte, *The Law of International Trade*, p. 305.

The trend is indicated, for example, by the application of foreign law in domestic courts. As mentioned earlier, domestic courts often state the application of a foreign law but then proceed to apply their own **non-provincial** notions.²⁵⁹ This approach, in particular, applies to the notion of fraud: Coing and Bertrams agree that ‘in view of the transnational nature of bank guarantees the specific notion of fraud in the context of guarantees should not be derived from the general notion of fraud as it exists in domestic law, but from an autonomous and transnational appraisal’.²⁶⁰ An international notion of fraud is for the first time laid down in the Uncitral Convention that may serve, as suggested, as guideline in the context of unfair calls.²⁶¹

The mentioned development is reflected in case law too. The Court of Appeal in CA The Hague, June 8 1993, for example, held that the meaning of an ‘extend or pay’ request had to be determined in accordance with internationally accepted notions and that the applicable law of Yemen was assumed to adhere to these notions.²⁶²

In light of the described trend, it is advisable that one does not limit the view to national borders in case of dealing with bank guarantees in international trade.

It is important to emphasize that the number of demands for payment is relatively small when compared with the large number of bank guarantees issued in the course of international commercial transactions. In relation to the demands for payment, the number of alleged cases of fraud is extremely small. According to figures of a leading German bank, about 10,000 guarantee instruments were issued within one year. Demands for payment have been made under 64 of these instruments and in two cases, a fraudulent call has been alleged.²⁶³

However, these figures pertain only to the economic significance of fraud as problem in the context of bank guarantees, but do not reflect the situation of a single account party.

²⁵⁹ See chapter 4 B I.

²⁶⁰ Bertrams, *Bank Guarantees in International Trade*, p. 323; Coing, ‘Probleme der internationalen Bankgarantie’, *Zeitschrift für das gesamte Handelsrecht und Wirtschaftsrecht* 1983, 125 at 133, 139 et seq.

²⁶¹ See chapter 4 C II 4.

²⁶² Kort Geding 1993, 301.

One should be aware of the fact that only one unjustified demand can be enough to bring about one's ruin.²⁶⁴

Independent bank guarantees, on the one hand, convey protection for the beneficiary against breach of contract. But on the other hand, the more unconditional the guarantee is, the more powerful the beneficiary's weapon becomes.²⁶⁵ Accordingly, the account party should spend sufficient time for negotiations about the text of the guarantee in order to limit the beneficiary's power. This is at least as important as the time spent on negotiations about the substantive contract.²⁶⁶

²⁶³ Poulet, 'Les garanties contractuelles dans le commerce international', *Droit et Pratique du Commerce International* 1979, 387 at 426; The cited figures date from 1979, but have generally been confirmed as up-to-date by the German bank Bankhaus Neelmeyer, Hansesstadt Bremen.

²⁶⁴ Rubino-Sammartano, 'Performance Bonds: Primary or Secondary Obligations?', *International Business Lawyer* 03/1985, 125 at 125.

²⁶⁵ See chapter 3 B II 1.

²⁶⁶ See chapter 1.