

University of Cape Town
School for Advanced Legal Studies

MINOR DISSERTATION

**'PERFORMANCE GUARANTEES ON FIRST DEMAND
AND THE FRAUD EXCEPTION IN INTERNATIONAL
TRADE'**

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(LL.M. by Coursework)

COMMERCIAL LAW 2007

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Research dissertation (23,465 words) presented for the approval of Senate in fulfilment of part of the requirements for the LL.M. by Coursework in approved courses and a minor dissertation. The other part of the requirement for this qualification was the completion of a programme of courses.

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– SCRIPTURE –

INTRODUCTION

In international trade the need for securities occurs with respect to two main objectives of a transaction: the performance by the seller and the payment by the buyer.

Due to the international character of the transaction payment as well as performance can be problematic. Besides usual difficulties that can occur in every trade transaction an international transaction bears further risks for both parties. Seller and buyer, however, may not know each other and each is concerned over the other's solvency and reliability. Furthermore, the parties usually have their places of business in different countries. Therefore, they are often subject to different legal systems. Both parties possibly might have little knowledge of the applicable foreign law that will govern many facets of the transaction. Depending on the type of transaction, constructions might have to be done over a long period of time or goods might have been transported far distances. The seller might be concerned that the buyer, after the seller has gone to the expense of loading and shipping his goods to an unfamiliar country, may refuse to pay or become insolvent. Similarly, the buyer might be worried that the goods, that will arrive, do not conform to the underlying agreement. He might have already paid in advance or the seller might become insolvent. Both parties then would have to go to great financial and administrative expense to sue the other party in an unfamiliar foreign jurisdiction with respect to the applicable law, the legal proceedings and matters of enforcement.

Taking aspects such as jurisdiction, culture, political risks, distance, transport, currency or language into account, it becomes obvious that there is an understandable lack of confidence with respect to both parties. Therefore, both have a legitimate interest to ensure their objectives: The seller to receive payment once he has left possession of the goods and the buyer to receive conforming goods in terms of manner, quality, quantity and time or place of delivery.

I. COMMERCIAL LETTER OF CREDIT

Commercial letters of credit have become widely used and acknowledged to secure the seller. A commercial letter of credit also known as documentary credit serves to reduce the risk of non-payment under a contract for sale of goods. It enables the seller to obtain payment from a bank as it is payable on presentation of certain documents, which confirm that the delivered goods conform to the terms and conditions of the underlying sales

agreement.¹ To furnish a letter of credit the buyer thus applies to a bank to issue an undertaking to make payment to the seller, once the bank receive certain, specified and agreed upon documentation² from the seller or from third persons. The documents are to record certain facts or conditions with respect to the proof of the fulfilment of the seller's obligations under the sales agreements. The documents usually include shipping documents, commercial invoices, packing lists, insurance documents and a set of clean on board bills of lading. If the submitted documents comply strictly with the terms of the letter of credit, the issuing bank is obliged to pay the seller in accordance with the terms of the letter of credit, so called doctrine of strict compliance.³ Hence, the letter of credit is an automatic consequence⁴ at a certain stage of the transaction, which will occur if the seller fulfils his obligations properly. Thus, it can be seen as a substitute of payment, which displays the payment function of a letter of credit.

II. PERFORMANCE GUARANTEE

The counterpart thereto is the performance guarantee that serves to reduce the risk of non-performance by the seller. Synonymously terms like bank guarantee, performance bond or standby letter of credit are used.⁵ A performance guarantee shares many of the characteristics of commercial letters of credit. In general, the beneficiary (for example a buyer) can obtain payment by the issuing bank, if the conditions as stated in the guarantee have been fulfilled. The conditions are usually of documentary nature.⁶ Therefore, the bank generally has to pay, if the terms and conditions of the guarantee are met. Unlike commercial letters of credit, that secure payment in the event of regular performance of an obligation, the performance guarantee is designed as a default instrument to provide financial compensation in the event of non-performance of the debtor.⁷ As that financial compensation in the event of (alleged) non-performance shall be provided quick and without in-depth investigation, it constitutes the liquidity function of the performance guarantee.

With respect to both securities the fraud exception is practically essential as it provides one if not the only opportunity to restrain from payment under the security. Furthermore, the fraud exception is of legal and dogmatic importance and interest as it represents the departure from the cardinal principle that governs the law of commercial letters of credit

¹ Oelofse, p. 7 ff.

² Oelofse, p. 7 ff

³ Gao, p. 26 f., Westphalen, Exportfinanzierung, p. 240 f.

⁴ Wallace, Hudson's Contracts, p. 1543 rec. 17-056

⁵ See below: Chapter A I. 1.

⁶ Bertrams, p. 2

⁷ See: Gao, p. 6

and independent guarantees: the principle of independence. As much was already written about the fraud exception and commercial letters of credit, this work focuses on independent guarantees, especially performance guarantees on first demand. The purpose of this analysis is to determine if and how the fraud exception applies to performance guarantees on first demand. Due the aforementioned limited scope of that analysis and for reasons of clarity the examination is expressly limited to direct guarantees. Thus, more complex structures, for example the involvement of a second bank in an indirect guarantee or matters of counter guarantees are intentionally disregarded.

The work is divided into three chapters. Whereas chapter A provides an overview of the performance guarantee in general, chapter B analysis the fraud exception and their current approach especially to independent guarantees in consideration of the laws of the U.S., England, Germany and, as far as applicable South Africa. Chapter C will discuss the similarities and differences between letters of credit and performance guarantees in that respect and draw the conclusion how the fraud exception should apply particularly to performance guarantees on first demand.

CHAPTER A. THE PERFORMANCE GUARANTEE ON FIRST DEMAND

I. OVERVIEW

1. Terminology

As mentioned above the performance guarantee has many names: bank guarantee, independent guarantee, on-demand guarantee, performance guarantee on first demand, unconditional bond, performance bond or standby letter of credit.⁸ First of all it shall be mentioned that performance guarantee in terms of this study means an independent guarantee.

Due to the adoption of English and American terminology by Continental banking and legal practice there was confusion, uncertainty and inconsistency with respect to ‘guarantees’.⁹ Originally, especially in Continental law jurisdictions, the term ‘guarantee’ denoted a suretyship contract in which the surety (guarantor) assumes liability for the debt or default of another.¹⁰ Therefore, the surety’s liability is accessory and secondary. In other words, the surety’s obligation to pay does not arise until the principal debtor has defaulted.

⁸ See: Gao, p. 8

⁹ Bertrams, p. 4

¹⁰ Schmitthoff, p. 379

It is limited to the liability of the principal debtor.¹¹ This kind of guarantee therefore is an ‘accessory’, ‘secondary’ or ‘conditional’ guarantee.¹² In Continental law jurisdictions this kind of accessory security henceforth is called ‘suretyship’.¹³ Today, especially in terms of international trade, a bank guarantee or another contract guarantee has most often the meaning of an independent and primary undertaking by the guarantor to pay if the specified conditions of the guarantee are met.¹⁴

The English law does not principally distinguish. Traditionally ‘guarantee’ meant an accessory guarantee. Today the term guarantee is used more neutrally, whereas distinction are made by the terms and conditions or additional terms such as ‘independent’, ‘on demand’ or ‘primary’ on the one hand and ‘conditional’ or ‘secondary’ on the other hand.

In American law and practice the term ‘guaranty’ described and still describes an accessory security, wherein the guarantor’s obligation is accessory and secondary to that of the principal debtor. This is one of the reasons why the independent security in American law is described by the term ‘standby letter of credit’.¹⁵ Therefore, the American standby letter of credit letter and the independent guarantee represent conceptually and legally the same device.¹⁶ In other words, the standby letter of credit is the American equivalent to the Continental independent guarantee.¹⁷ Accordingly, the United Nations Commission on International Trade (UNCITRAL) regulated both of them in the 1995 UNCITRAL Convention on Independent Guarantees and Standby Letters of Credit (The UNCITRAL Convention). Art. 2 sub. 1 UNCITRAL Convention therefore covers and treats both the independent guarantee and the standby letter of credit principally in the same way.

In order to avoid misunderstandings this study generally uses the term ‘guarantee’ in general and ‘performance guarantee’ in particular for the following analysis. The term ‘performance bond’ should be avoided, as ‘bond’ is more a financial than a legal term. Furthermore, so called ‘performance bonds’ are typically issued by insurances and bonding companies in the Anglo-American jurisdiction in construction contracts,¹⁸ but this study will provide a more general analysis of performance guarantees. Corresponding to the UNCITRAL Convention this study uses the term ‘guarantee’ in delineation to the sole American term of ‘standby letter of credit’. With respect to the special purpose of the

¹¹ See: Goode, Commercial Law, p. 1030

¹² See: Gao, p. 8

¹³ Bertrams, p. 4

¹⁴ Schmitthoff, p. 380

¹⁵ Bertrams, p. 4

¹⁶ Bertrams, p. 7; Goode, ICC Uniform Rules, p. 16

¹⁷ Bertrams, p. 1, 5

¹⁸ See: Bertrams, p. 5

guarantees here examined, the term ‘performance’ is added.¹⁹ ‘Performance guarantee’ illustratively describes the meant security as broadly as necessary and as precisely as possible.

2. Historical Establishment

The performance guarantee can be described as originated from practical needs. On the one hand letters of credit and independent guarantees in general were banking inventions to circumvent legislative obstacles. Firstly, the American banking system is according to the Glass-Steagall Act 1933 strictly divided between investment banking and commercial banking. To act beyond the legitimate scope thereafter will result in the invalidity of the transaction, as it would be *ultra vires*.²⁰ Therefore, only those banks that have permission for commercial banking were generally allowed to issue commercial securities.²¹ These so called Commercial Banks had to deal with further certain restrictions. First of all, only National Banks, that means federally licensed banks,²² were able to issue commercial securities for international trade.²³ Another restriction was made with respect to the kind of security that could be issued legally. Due to the American National Bank Act of 3 June 1864 Commercial Banks were not allowed to act as guarantor for other’s debts. It was believed to be the competence of insurances and bond companies to answer for the debts of others.²⁴ Accordingly, banks could not issue accessory or conditional guarantees.²⁵ Interestingly the prohibition to act as suretyship was and is based on considerations that a bank shall not assess if the potential debtor will default nor shall it investigate the underlying agreement to answer the question if there was default to identify whether it has to pay under the guarantee or not.²⁶ The banks established a ‘new’ field of activity in issuing letters of credit. Although that was also a kind of guaranteeing for potential debts of others, that practice became well established and vastly unopposed.²⁷ One reason therefore might have been the fact that banks indeed principally do not need to investigate the underlying agreement in the event of a letter of credit. In general, payment under a letter of credit depends solely on the presentation of documents as specified in the credit.

¹⁹ See below: 3.2

²⁰ Westphalen, Bankgarantie, p. 400

²¹ Westphalen, Bankgarantie, p. 400

²² In contrast, it was believed that State Banks (licensed within one federal state only) should not act within international trade.

²³ Westphalen, Bankgarantie, p. 400

²⁴ Bertrams, p. 6

²⁵ Bertrams, p. 6

²⁶ Bertrams, p. 6

²⁷ Bertrams, p. 6

The beginning of an establishing of standby letters of credit and independent guarantees is seen in the 1950'ies.²⁸ Lastly, in the 1960'ies standby letters of credit were widely used in U.S.; worldwide they have become popular since the 1970'ies.²⁹ Today, the power of banks in general and of American banks in particular of acting as independent guarantors is widely established and acknowledged.³⁰

On the other hand the development of performance guarantees is based on customer needs. As briefly described above the traditional commercial letter of credit, that occurred in the today known form firstly in the middle of the nineteenth century,³¹ serves to reduce the risk of non-payment by the buyer. In the event of regular performance of contractual obligations the seller can obtain payment from the issuing bank on presentation of specified documents. Due to increasing international trade the need for a broader form of security that provides not solely security in the event of regular performance but also in the event of default accrued. Also the market requested a buyer's security in international trade. Alongside already existing accessory securities as suretyships, an independent security is doubtless more favourable for the beneficiary as he obtains a second, generally independent and solvent debtor. Due to its independent character the call for the performance guarantee generally does not depend on the dispute with respect to the default in question. In general the drawdown of a performance guarantee solely depends on the demand by the beneficiary, that means a presentation of a document attesting that the principal debtor (for example the seller) has not, not timely, or not properly performed its obligations.³² That, compared to the commercial letter of credit, relatively low threshold of requirements constitutes the attractiveness of the performance guarantee as independent security in favour of the buyer. In equal measure it also constitutes the high risk of a performance guarantee for the principal debtor. Independent guarantees and standby letters of credit generally serve in a broad range of transaction. As *Dolan* stated: 'There are virtually no limits to the variety of transactions that the standby letter of credit can serve. In principle, standby letters of credit can be used in any contract where the performance of one party is executory.'³³ Independent guarantees in general and performance guarantees in particular are today most common in international trade and therefore widely used, especially within the construction industry, in international sales of goods and in financial transactions.³⁴

²⁸ See: Gao, p. 5

²⁹ Gao, p. 5

³⁰ Bertrams, p. 6

³¹ Gao, p. 11

³² See below: II. for further details

³³ Dolan, 1-24

³⁴ See Gao, p. 6

3. Classification

3.1 Guarantees for Financial and Non-financial Obligations

Within guarantees that are subject to this study, the main distinction is made between guarantees for financial obligations and those for non-financial obligations. The first type secures financial obligations such as the payment arising out of a sales contract, those of the borrower out of a loan contract or those of an employer. The second type secures a broad variety of non-financial obligations. The 1995 UNCITRAL Convention mentions three main types of guarantees: As examples of guarantees for non-financial obligations the performance guarantee – whereas payment is due because of a default in the performance of an obligation – and the tender guarantee – whereas payment relates to contingency. As example of a guarantee for financial obligations the repayment guarantee, that serves to provide payment in the event of a loan or any other borrowed money, is mentioned. As this study focuses on performance guarantees, guarantees for financial obligations are not taken into closer consideration.

3.2 Subtypes of Guarantees for Non-financial Obligations

Within guarantees for non-financial obligations a further subdivision can be made with respect to the particular purpose of the guarantee. Mainly, tender, performance and warranty guarantee are to be mentioned. The different subtypes correspond with the successive stages of a contract.³⁵ Especially the performance guarantee will be determined more closely later on.³⁶ Besides these main types, banks, insurance companies and other third parties issue a broad variety of guarantees. The exceeding example of possible types of guarantees that are conceivable and indeed practiced is the so called superguarantee that can be understood as a guarantee's guarantee.³⁷ Generally, the variety of guarantees come along with the variety of risks that attend the conclusion and execution of contracts; they basically serve the same overall purpose, the reduction of the risk of non-performance.³⁸

(1) Tender Guarantee

In the early phase of an international construction or sale of goods contract tender guarantees (or guarantees for preliminary deposit) are frequently used. They serve to ensure that the bidder does not withdraw or change his declared offer before adjudication,

³⁵ Bertrams, p. 37

³⁶ See below: (1) to (3)

³⁷ See: Schmitthoff, p. 381 with further evidence

³⁸ See: Bertrams, p. 37

but will accept and sign the contract if awarded to him.³⁹ Ordinarily, the amount of a tender guarantee is between one and five per cent of the contract price. Numerously the tender regulations require bidders to serve a performance guarantee within a specified time after adjudication.⁴⁰

(2) Performance Guarantee

The most commonly used guarantee in international trade is the performance guarantee. As mentioned above it serves protection against non-performance of a contractual obligation such as the contract conforming delivery of goods or the contract conforming construction. As the performance guarantee is the counterpart of a commercial letter of credit⁴¹ most of international construction or sales of goods contracts provide for at least two securities: a commercial letter of credit in favour of the seller/employer and a performance guarantee in favour of the buyer/contractor.

The performance guarantee assures payment in the event that the seller or employer has not, not timely, not completely or not properly exercised his obligations out of the underlying agreement. Therefore, it usually does not cover the whole amount of the project value. The covered amount usually ranges from five to ten per cent of the contract value. It is expressed in the maximum amount of the guarantee. In particular the percentage depends on the type of contract, the relating risk of non-performance, the total value⁴² and the business relation of the parties involved. Due to the fact that sellers/employers prefer the full contract price at once, the security deposit or the right to obtain a certain percentage of the contract price can be replaced by a performance guarantee.

The common text of a performance guarantee contains the description of the guarantee's purpose: In general, the compensation in the event of non-performance by the account party. The coverage of the guarantee differs according to the type of underlying contract. In terms of particular contents it can include delivery of goods, installation, or operation; in terms of the spread it principally covers main obligations as well as any additional obligations that form part of the principal contract, unless expressly stated otherwise.⁴³

It is arguable if secondary obligations during the warranty period are also covered by an ordinary performance guarantee. The German point of view is that a performance guarantee does cover only primary contractual obligations and therefore does not cover

³⁹ Bertrams, p. 38

⁴⁰ See: Bertrams, p. 38

⁴¹ See above: Introduction II.; also: Bertrams, p. 39

⁴² Often it can be said: The higher the total value, the lower the percentage

⁴³ Bertrams, p. 39 f.

secondary or warranty obligations. If intended otherwise, these obligations would have to be covered by a separate warranty (or maintenance) guarantee⁴⁴. It is argued, that this point of view cannot find any support at all by the texts of crossborder performance guarantees.⁴⁵ Therefore, a performance guarantee in international trade principally would cover also warranty obligations.⁴⁶

As it depends on the precise wording of the guarantee in question, a universally valid answer is not possible and also not necessary at that point of this analysis. If there was a separate warranty or maintenance guarantee or if the principal contract included the obligation to serve such a warranty guarantee within a specified time, it could be concluded that the performance guarantee does not cover secondary obligations principally. If, contrary, there was no further specification or/and no warranty guarantee, the interpretation of the guarantee's text could lead to the result that secondary obligations are covered as well. In the event of a needed interpretation the expiry date of the performance guarantee may serve as revealing indication. A performance guarantee that expires with or around completion of the primary contractual obligations and therefore does not cover the warranty period is less likely to cover warranty obligations than a guarantee with a duration of validity that equals the warranty period.

Principally the covered obligations and risks should be described precisely. In the event of complex projects and/or long periods of time multiple performance guarantees are used, specifying the covered obligations of each segment or stage of the entire project.⁴⁷ Then the instalment of clauses is common, which govern that successive guarantees do not enter into force until the release of the precursory guarantee in order to avoid simultaneous running.⁴⁸

(3) Warranty or Maintenance Guarantee

The already mentioned warranty guarantee consequently serves to reduce the risk of non-performance with respect to the secondary or warranty obligations of the applicant. Thus, it covers the maintenance or warranty period of the underlying contract. As the extent of that risk is principally lower than the extent of the risk of non-performance of the whole contract the covered amount tends to be lower than that of a performance guarantee. Similar to the performance guarantee the issuing of a warranty guarantee is often used to

⁴⁴ Westphalen, p. 39

⁴⁵ Bertrams, p. 39

⁴⁶ Bertrams, p. 39 f.

⁴⁷ See: Bertrams, p. 40

⁴⁸ Bertrams, p. 40

receive the last instalments of the contract price, that is withhold by the employer as security for warranty works or other repairs.⁴⁹

4. Sources of Law

It was already mentioned that performance guarantees as well as letters of credit were originated by practical needs and therefore their law was developed widely through custom, especially the custom of banks and insurances dealing with importers, exporters and other international players. Gradually those customs were embodied in two main types of set of rules: binding statutes (e.g. Art. 5 UCC) or model laws (e.g. the UNCITRAL Convention), coming into effect due to adoption by a country, and principally voluntary rules that come into effect on a contractual basis. With respect to the latter International Chamber of Commerce (ICC) is of material importance. The common purpose of rules and conventions set out by the ICC or UNCITRAL (United Nations Commission on International Trade) is to introduce a universal legal framework that serves to unify and standardize the international law. Bearing the highly international character of these securities in mind, the general importance of acknowledged and esteemed set of rules becomes obvious.

4.1 The ICC Rules

(1) UCP

The oldest rules to be mentioned are the Uniform Customs and Practice for Documentary Credits (UCP), which were introduced by the ICC in Vienna 1933. The UCP dealt with (commercial) letters of credit and can be described as an early stage of the drive for uniformity.⁵⁰ The UCP 1933 version was adopted by some practitioners in the U.S. and in some European countries, except the United Kingdom.⁵¹ Within the following decades the UCP was revised and modified several times,⁵² which generally led to increasing acknowledgement and acceptance. After the 1962 revision also bankers from the UK and the Commonwealth adopted the UCP as this revision had the expressed purpose to meet their particular needs.⁵³ The UCP 1983 version firstly contained guidelines with respect to standby letters of credit. The latest UCP version, published as ICC Publication No. 600, comes into effect on 1 July 2007. In 2002 the Uniform Customs and Practice for Documentary Credits for Electronic Presentation (eUCP) came into effect. It has been

⁴⁹ See: Bertrams, p. 41

⁵⁰ See: Gao, p. 15 f.

⁵¹ Most of the Commonwealth countries also refused to adopt the UCP

⁵² 1951, 1962, 1974, 1983, 1993, 2002

⁵³ See: Ellinger, [1984] LMCLQ, 578 (580)

initiated and drafted to adjust with the development of electronic trade. Thus, it covers - amongst other things - the relationship between eUCP and UCP, format, presentation and the examination of electronic records.⁵⁴ ‘All articles of the eUCP are consistent with the UCP except as they relate specifically to electronic presentations’.⁵⁵

(2) URCG

In 1978 the ICC introduced the Uniform Rules for Contract Guarantees (URCG). Its purpose was, apart from creating uniformity, to set out standard rules for enhancing more equitable practices and reducing the risk of abuse in the field of contract guarantees, especially performance guarantees in international projects.⁵⁶ However, the URCG have remained widely unaccepted and unused.⁵⁷ The reasons for the non-acceptance seem to be manifold. Conceptual problems have been that the URCG firstly, did not provide for guarantees on first demand⁵⁸ and secondly, that it has not made clear that it is not confined to accessory guarantees.⁵⁹ Furthermore, the provision set out in Art. 9 of the URCG that should reduce the risk of abuse appeared to be a material obstacle. It required the beneficiary to serve a judgement or arbitral award or the principal’s written approval to call for the guarantee, but it has proved too far removed from market practice and market needs.⁶⁰

(3) URDG

With the experience of the URCG’s limited success the ICC introduced the Uniform Rules for Demand Guarantees (URDG) containing a more comprehensive and detailed body, including first demand guarantees. The URDG should replace the URCG to gain general acceptance,⁶¹ but the URCG has not yet been fully abandoned.⁶² Despite the broader approach of the URDG and the more detailed body of rules, the URDG have not yet gained broad acceptance.⁶³ The reasons therefore are less of conceptual than of mistakable nature. It is submitted that there are fears of practitioners that the URDG could clash with standard guarantee texts ordinarily used.⁶⁴ That appears to ignore that any of the Rules can be

⁵⁴ See: Gao, p. 19

⁵⁵ ICC Banking Commission doc. 470/941rev3, ‘Note to National Committees and Members of the Banking Commission’, 12 October 2001

⁵⁶ See: Bertrams, p. 28; Gao, p. 19

⁵⁷ See: Bertrams, p. 28; Gao, p. 19

⁵⁸ Bertrams, p. 28

⁵⁹ Gao, p. 19

⁶⁰ Goode, [1992] LMCLQ, 190 (190)

⁶¹ Goode, ICC Uniform Rules, p. 24

⁶² See: Gao, p. 20

⁶³ See: Bertrams, p. 29, Gao, p. 20

⁶⁴ See: Bertrams, p. 29

excluded or modified by contractual clauses and the agreement of the parties thereto. The more important reason seems to be that neither account parties nor beneficiaries expressly ask for the incorporation of rules.⁶⁵ That fact might base upon acknowledged trade customs and familiar practices within international operating practitioners that can be assessed constantly when reviewing the development and law of performance guarantees in international trade.

The URDG is of contractual nature and therefore it requires the explicit or implicit consent of the parties, usually exercised by virtue of an incorporation clause in the guarantee (Art. 1 URDG).⁶⁶ Due to the contractual nature the URDG can be described as voluntary rules or self regulation. Thus, the parties are free to exclude or modify any of the rules provided. Generally the URDG is not an exhaustive set of rules, but a comprehensive one.⁶⁷ The URDG is primarily intended for transnational use, for example in transactions with parties from different countries or cross-border transactions. However, the rules might also apply in domestic transactions.⁶⁸ Of the contents the URDG establishes the independence of the guarantee from the underlying agreement (see Art. 2 lit. (b) URDG). It also provides rules for documentary and formal conditions of payment (see Art. 2 lit. (b), Art. 9 URDG). Interestingly, the URDG – as well as the other ICC rules – does not contain any provision regarding fraudulent or abusive demand for payment.

(4) ISP98

With particular respect to American standby letters of credit the International Standby Practices, revised and adopted by the ICC in 1998 (ISP98), are to be mentioned. Due to the fact that the UCP initially did not provide for independent guarantees and therefore not for standby letters of credit, the ISP98 was initiated by the American Institute of International Banking Law & Practice. It contains a complex and detailed set of rules that contrasts with the concise provisions of the URDG.⁶⁹ Nonetheless, URDG and ISP98 equal each other in certain main objectives. For example the ISP98 is of contractual nature, it emphasises the independence of the standby letter of credit from the underlying relationship and it contains provisions with respect to documentary and formal payment requirements, too.

⁶⁵ See: Bertrams, p. 30

⁶⁶ Goode, ICC Uniform Rules, p. 24

⁶⁷ Bertrams, p. 33

⁶⁸ Bertrams, p. 33

⁶⁹ Bertrams, p. 31

4.2 The UNCITRAL Convention

The UNCITRAL Convention on Independent Guarantees and Standby Letters of Credit, drafted from 1988 to 1995, entered into force on 1 January 2000. By now the Convention was ratified by Belarus, Ecuador, El Salvador, Gabon, Kuwait, Liberia, Panama and Tunisia as well as signed by the U.S..⁷⁰ It appears that the Convention is especially useful for countries with less developed regimes for independent guarantees.⁷¹ According to its name it applies for independent guarantees as well as for standby letters of credit (Art. 2 sub. 1). The application is defined as international undertaking (guarantee or standby letter of credit), whereas ‘the place of business of the guarantor/issuer ... is in a Contracting State’ (Art. 1 sub. 1 lit. (a)) or ‘the rules of private law lead to the application of the law of a Contracting State’ (Art. 1 sub. 1 lit. (b)).

In contrast to the voluntary rules of the ICC the UNCITRAL Convention is drafted as a uniform law or official regulation for countries, which adopt it. Thus, it provides a more comprehensive set of rules that expressly contains – in particular contrast to the ICC rules – provisions in respect to demands without conceivable basis⁷² (Art. 19, 20).

4.3 Art. 5 UCC

Although Art. 5 of the Uniform Commercial Code (UCC) again⁷³ deals particularly with American letters of credit, both the commercial letter of credit and the standby letter of credit, this legal source is to be mentioned as it is of some material importance. The UCC is a collection of model laws drafted and recommended by the National Conference of Commissioners of Uniform State Laws (NCCUSL) and the American Law Institute (ALI), to be adopted by the federal states. It contains 11 articles, each covering different aspects of commercial law.⁷⁴ Art. 5 UCC governs the law of letter of credit. It was revised lastly in 1995 and thereafter adopted by 50 states of the U.S..⁷⁵ Besides the UCP, in the U.S. Art. 5 UCC is considered as most significant source of law with respect to letters of credit.⁷⁶ Art. 5 UCC expressly recognizes the UCP 500.⁷⁷ Thus, it is in many instances consistent with and complementary to the UCP 500.⁷⁸ As the UCP 600 changed did not change

⁷⁰ See: http://www.uncitral.org/uncitral/en/uncitral_texts/payments/1995Convention_guarantees_status.html

⁷¹ Bertrams, p. 28

⁷² Terms like ‘bad faith’, ‘abuse’ or ‘fraud’ were deliberately avoided as they have at least inconsistent meanings in various legal systems.

⁷³ Like the ISP98 mentioned in 4.1 (4)

⁷⁴ Gao, p. 21 f.

⁷⁵ See: http://www.nccusl.org/Update/uniformact_factsheets/uniformacts-fs-ucca5.asp

⁷⁶ See: Gao, p. 22 with further evidence

⁷⁷ See: http://www.nccusl.org/Update/uniformact_why/uniformacts-why-ucca5loc.asp

⁷⁸ Gao, p. 23

significantly in terms of its material content, Art. 5 UCC is still consistent with it in many aspects.

But, Art. 5 UCC is, like the UNCITRAL Convention, drafted as a statute. Therefore it also contains provisions regarding liabilities and responsibilities, in particular also a provision with respect to the fraud rule: Art. 5 sec. 5 – 109 UCC. These certain contents form the major difference between Art. 5 UCC and the UCP (and other ICC rules).⁷⁹

4.4 National Laws and Regulations

In most countries a specific legislation on independent guarantees does not exist. Only a very few countries, like the Czech Republic, former Yugoslavia, Bahrain or Kuwait have some statutory provisions of general nature.⁸⁰ The fifteen OHADA⁸¹ countries in West Africa have adopted uniform legislation (the Uniform Act on Securities) that is partly derived from the URDG.⁸² Some countries in the Middle East and in North Africa have introduced mandatory regulations regarding independent guarantees.⁸³ Whereas knowledge about the legal nature and the effect of these national laws and regulations are of material importance for practitioners, these provisions are of minor importance as legal source within the scope of this analysis. Thus, it will not be exercised more closely.

4.5 Case Law and Legal Writing

Significant sources of the law of independent guarantees are case law and legal literature, depending on the particular jurisdiction. It is said that there has been a steady flow of case law since 1977; especially the Iranian revolution of 1979 – 1980 caused a major bulk of international disputes with respect to independent guarantees.⁸⁴ In continental Europe legal writing is to be considered as major source of law for the development and formulation of principles of law regarding independent guarantees. The crucial case law as well as significant legal writing will be examined more closely and detailed at the relevant stages of determining the fraud exception.

⁷⁹ See: Gao, p. 23

⁸⁰ See: Bertrams, p. 35

⁸¹ Organisation pour L'Harmonisation de Droit des Affaires en Afrique

⁸² See: Bertrams, p. 35

⁸³ See: Bertrams, p. 35

⁸⁴ Bertrams, p. 36

II. GENERAL FUNCTIONING

1. Introduction

Introductory, it appears to be useful to describe the general functioning of a performance guarantee on first demand, especially the conditions of payment, briefly. That will enable assessing the extraordinary character of the fraud exception in legal and dogmatic as well as in practical terms and will help to draw the scope of application.

2. Principle of Independence

Generally, apart from specifically agreed terms and conditions, a demand guarantee is the promise of the guarantor to pay a certain amount of money to the beneficiary on his demand. It is an abstract payment undertaking that is independent from the underlying contract between principal and beneficiary. It becomes binding solely by virtue of its issue. The fact that the guarantee intends to secure the beneficiary from loss out of the underlying transaction expressly does not alter the independent nature of the guarantee.⁸⁵

The so called principle of independence, which is embodied in Art. 2 lit. (b) URDG, constitutes the separation of guarantee in terms of validity, rights and obligations as well as objections and exceptions in general. Thus, the creditor is generally neither concerned with the underlying contract nor will he investigate the underlying contract before proceeding payment. In the absence of established fraud⁸⁶ or another acknowledged reason for non-payment under the applicable law, the guarantor is not entitled to refuse payment merely because of the dispute between the beneficiary and the principal as to whether the latter has in fact committed any breach of the underlying contract.⁸⁷

3. Payment Mechanisms

The principle of independence just tells us, what is not to be determined concerning questions of payment and that the characteristic pattern is the separation or independence of guarantee and principal contract; it does not provide positive requirements when and in what circumstances the beneficiary is entitled to demand payment.⁸⁸ That positive description is contained in the payment mechanisms, also known as conditions of

⁸⁵ See: Goode, ICC Uniform Rules, p. 14

⁸⁶ The fraud exception will be determined closely in Chapter B.

⁸⁷ Goode, ICC Uniform Rules, p. 18

⁸⁸ Bertrams, p. 47

payment.⁸⁹ These conditions determine the benefits of the beneficiary as well as the risk for the principal. As matters like the amount, duration, termination and the conditions of payment depend solely on the terms of the guarantee itself and as the possibly presentation of documents is specified in the guarantee itself, the guarantee is of documentary character.⁹⁰

3.1 Payment on First Demand

The most commonly used type of payment mechanism in international trade is the payment on first demand,⁹¹ on which this study focuses. Hereafter the beneficiary is entitled to payment by submission of his demand solely. He does not need to submit any evidence or confirmation with respect to the assumed default or to his entitlement.⁹² In other words, the only condition to be fulfilled in the event of a guarantee on first demand is the presentation of a demand for payment, which is usually required to be in writing.⁹³ The beneficiary can claim the full guarantee amount without specification of proof or loss. When the beneficiary demands payment according to the conditions specified in the guarantee, the bank is not permitted to ask for any evidence nor do any doubts and queries influence the bank's obligation to proceed payment in general.⁹⁴ Considering these features it becomes obvious that the validity and enforceability of guarantees on first demand were contested in legal community and judiciary. Descriptive is the statement of Kerr J in *R D Harbottle (Mercantile) Ltd v. National Westminster Bank*: 'Performance guarantees in such unqualified terms seem astonishing, but I am told that they are by no means unusual...'⁹⁵ Nowadays guarantees on first demand are widely accepted and acknowledged.⁹⁶

Within guarantees on first demand a further distinction with respect to the type of demand can be made. The so called simple demand guarantee requires not more than the beneficiary's demand for payment. The other type of guarantee on first demand additionally requires the submission of a statement of the account party's default. Due to the documentary character this statement merely entails a formal, unilateral declaration by the beneficiary without any evidence.⁹⁷ Despite that merely formal and unilateral character the need to express his position might cause a psychological threshold to call on a

⁸⁹ Bertrams, p. 47

⁹⁰ Goode, ICC Uniform Rules, p. 19

⁹¹ See: Bertrams, p. 48; Goode, ICC Uniform Rules, p. 9, Wallace, Hudson's Contracts, p. 1542 rec. 17-054 f; Westphalen, Bankgarantie, p. 78, 84

⁹² See: Bertrams, p. 48

⁹³ Goode, ICC Uniform Rules, p. 21

⁹⁴ Bertrams, p. 48

⁹⁵ *R D Harbottle (Mercantile) Ltd v National Westminster Bank*, [1977] 2 All ER 862 (864 f) (QB)

⁹⁶ Bertrams, p. 49; Goode, ICC Uniform Rules, p. 8 ff; Wallace, Hudson's Contracts, p. 1542 rec. 17-055; Schmitthoff, p. 383; Westphalen, Bankgarantie, p. 78, 84, 164

⁹⁷ Bertrams, p. 49

guarantee unfairly rather than in the event of a simple demand guarantee.⁹⁸ Sometimes the requirement to submit a formal notice to the principal before calling on a guarantee is to be found. That serves to enable the account party to try to settle the dispute with the beneficiary and, if the principal considers a call to be unjustified, to submit the necessary information to the bank in order to prevent unjust payment.

If the guarantee is subject to the URDG, Art. 20 lit. a URDG requires the demand for payment in writing as well as the submission of a written statement containing the allegation that the account party is in breach of contract and the particular respect in which he is in breach. The purpose of this provision, that was one of the most controversial ones,⁹⁹ is to discourage unfair calling whilst sustaining a sufficient level of speed and simplicity of remedy.¹⁰⁰

Despite the abovementioned it is to be pointed out that a first demand guarantee, whether one on simple demand or one requiring a statement of default, constitutes high risks for the principal. The beneficiary is provided with a very advantageous position; he is *de facto* able to call the guarantee and therefore receive payment at any time he thinks or he alleges that the account party is in default. As both parties know this right of immediate payment without proof, which underlines the liquidity function of that guarantee, it enables the beneficiary to put serious pressure on the principal.¹⁰¹ Very descriptive is the American parlance with respect to guarantees on first demand as ‘suicide letters of credit’.¹⁰²

3.2 Alternative Mechanisms

This study focuses on guarantees on first demand only, because the matter of the fraud obtrudes significantly with respect to that most ‘dangerous’ guarantee. Despite that it shall not stay unmentioned that there are numerous legal possibilities of payment mechanisms the parties may agree upon. Firstly, the parties can agree upon specifications of the first demand, e.g. payment on ‘first justified demand’ or payment ‘in the event of demand’ as often practiced in German law¹⁰³. The legal effect of these terms is a matter of construction. Within an independent guarantee and without further clear indications these clauses just require the submission of a statement and do not constitute the need for evidence or corroboration.¹⁰⁴

⁹⁸ See: *Esal (Commodities) Ltd v Oriental Credit Ltd*, [1985] 2 Lloyd’s Rep 546 (550)

⁹⁹ Bertrams, p. 50

¹⁰⁰ Goode, ICC Uniform Rules, p. 21

¹⁰¹ See Bertrams, p. 52

¹⁰² Bertrams, p. 52

¹⁰³ ‘Effektivklauseln’

¹⁰⁴ See: Bertrams, p. 53 f.

The parties could also agree upon payment on submission of third parties documents or upon payment on submission of an arbitral or court decision. Obviously these mechanisms are likely to reduce the principal's risks and therefore he might prefer them, but these higher thresholds also impact the speed, simplicity and effectiveness of the performance guarantee as a security with liquidity function. Hence, the according Art. 9 URCG proved to be one of the main obstacles for the acceptance of the entire URCG.¹⁰⁵ Also, it must be considered that the employer or purchaser of an international commercial contract will hardly agree upon guarantees that are less advantageous for him, if another contractor or seller is willing to furnish the commonly used performance guarantees on first demand without any further restrictions concerning conditions of payment.

4. Guarantor's Limited Duty of Examination to Appearance of Good Order

Due to the principle of independence on the one hand and the documentary character of the guarantee, especially in respect to conditions of payment, on the other hand, the guarantor is not concerned with the investigation of external facts, such as the fact of the principal's default or the amount of loss the beneficiary actually suffered due to the default. The beneficiary's demand must solely comply with the conditions of the guaranty in respect to the demand, a possible statement and documents to be submitted. It appears that in the event of performance guarantees the doctrine of strict compliance, which has evolved in relation to commercial letters of credit, will not apply to the same protecting extent,¹⁰⁶ which again constitutes a comparatively lower threshold for the beneficiary to call his security.

Simultaneously, that constitutes the limited duty of the guarantor to examine the appearance of good order of the beneficiary's demand and submitted documents. Thus the guarantor is merely responsible for ascertaining whether the submitted statements and documents 'appear on their face' to conform to the requirements of the guarantee.¹⁰⁷ It can be concluded, that the guarantor therefore is not obliged to do more than conduct a reasonable visual examination and that his duty is limited to the exercise of good faith and reasonable care in the performance of his duties.¹⁰⁸ Those circumstances, namely the 'simple compliance' on part of the beneficiary and the limited duty to examine on part of the guarantor, may be of some material importance when determining the application of the fraud exception to guarantees on first demand. Therefore, it should be borne in mind.¹⁰⁹

¹⁰⁵ See above: I. 4. 4.1 (2)

¹⁰⁶ Wallace, Hudson's Contracts, p. 1549 rec. 17-064

¹⁰⁷ Goode, ICC Uniform Rules, p. 21

¹⁰⁸ Goode, ICC Uniform Rules, p. 21f

¹⁰⁹ See below: Chapter C II. 2.

5. Summary

The general functioning of a performance guarantee on first demand with respect to matters of payment is characterized by the principle of independence. As negative clue the principle tells us what is not to be determined. It constitutes the characteristic separation of guarantee and underlying contract. The guarantee is an abstract undertaking that becomes binding solely by virtue of issue. This separation continues with respect to the rights and obligations as well as to objectives and exceptions in general. Thus, the guarantor is not concerned with the underlying contract nor is he entitled to refuse payment merely because of a dispute between the principal debtor and the beneficiary with respect to the breach of the underlying contract.

The positive clue in respect of the question when and in what circumstances the guarantor is obliged to proceed payment and when and in what circumstances the beneficiary is entitled to receive payment is provided by the agreed upon conditions of payment within the guarantee. This constitutes the documentary character of the guarantee. It was shown that guarantees on first demand, whether those on simple demand or those requiring a statement of default, bear high risks for the principal debtor. They provide the beneficiary with a powerful and advantageous position due to the fact that the condition is the written demand and possibly the statement of default to be produced by the beneficiary without any evidence whatsoever. Correspondingly, the principal debtor's position is weak and disadvantageous.

Lastly, it was assessed that the guarantor's duty to examine the submitted documents is limited to the appearance of good order. That means that the documents solely have to appear on their face to conform to the guarantee's requirements. The guarantor does not need to do more than conduct a reasonable visual examination.

CHAPTER B: THE FRAUD EXCEPTION IN SPECIAL CONSIDERATION OF PERFORMANCE GUARANTEES

I. INTRODUCTION

The abovementioned remarks, especially in respect to the principle of independence and the conditions of payment under a performance guarantee on first demand clarified the perilous situation of the principal debtor once he has furnished this kind of security in favour of the beneficiary. One if not the only opportunity to restrain payment under a performance guarantee on first demand is the already mentioned fraud exception. The term

‘exception’ firstly indicates that the practical approach and use may be restrictive. Bearing the extraordinary character of an exception to a rule in mind, a restrictive approach seems to be principally comprehensible and appropriate. The second is that the fraud exception represents the departure from cardinal principles also in a legal and dogmatic respect.

Following the exact approach of that so called fraud exception will be showed by reviewing legal writing as well as case law in special consideration of the laws of U.S., England, South Africa and Germany. It will be determined if the indications are to be confirmed. The common elements within these jurisdiction as well as major differences will be pointed out, rather than exercising a comparative analysis in every detail. That frames the basis to answer the question how the fraud exception should be applied to performance guarantees on first demand. The current approach of the fraud exception will be determined in predominant consideration of their application to performance guarantees. As far as it seems necessary and useful case law concerning the fraud exception in the event of letters of credit will be examined as well.

Questions of jurisdiction and applicable law will be expressly disregarded, as these are aspects of particular cases subject to certain conditions and agreements. However, it can be mentioned, that although most of the case dealing with performance guarantees in international trade containing crossborder elements, it is submitted that private international law seems to be of minor importance.¹¹⁰

II. CONCEPT OF FRAUD

As described above the guarantor of a performance guarantee is obliged to pay the beneficiary without investigating the contractual positions, based on the principle of independence as well as on the payment mechanism of that particular security. The exception to this cardinal principle, the fraud exception, is common in most jurisdictions. Most legal systems consider it as to be unconscionable to insist on the guarantor’s payment to the beneficiary, if the beneficiary has been unscrupulous or fraudulent towards the principal debtor, despite the cardinal principle. The fraud exception relies on the maxim: *ex turpi causa non oritur actio*,¹¹¹ which generally means no action arises out of a dishonourable cause or in plain English ‘fraud unravels all’¹¹². The essence of the fraud exception is that the guarantor can either refuse payment, or can be prevented from making

¹¹⁰ See: Bertrams, p. 451 f.

¹¹¹ *United City Merchants Investments Ltd v The Royal Bank of Canada*, [1979] 1 Lloyd’s Rep 267 (268) (QB)

¹¹² *United City Merchants Investments Ltd v The Royal Bank of Canada*, [1983] 1 AC 168 (184)

payment, despite formal compliance with the terms and conditions of the guarantee, if there has been fraud by the beneficiary.

1. Standard of Fraud

The major issue is the definition what kind of facts and what kind of conduct in which circumstances, render a demand for payment fraudulent in terms of that exception such as to justify judicial intervention;¹¹³ the definition of a standard of fraud. After describing the general approach of the fraud exception and the pointing out of common elements in regard to the jurisdictions that are subject to this analysis (1.1), substantive aspects of fraud will be examined on a factual basis (1.2).

1.1 General Approach

The general approach of the standard of fraud displays striking similarities within the jurisdictions that are subject to this analysis.

(1) The United States

The illustrative introductory example and so called ‘landmark case’¹¹⁴ to the fraud exception the case of *Sztejn v J Henry Schroder Banking Corp*¹¹⁵ is to review. The U.S. decision was cited with approval or followed throughout the Common Law world.¹¹⁶

In that case *Schroder* issued a commercial letter of credit on behalf of *Sztejn* in favour of an Indian company, *Sztejn* contracted to buy bristles from. The Indian seller shipped fifty cases with ‘cow hair, other worthless material and rubbish’¹¹⁷ instead of the goods purchased in the underlying contract, but submitted the documents required by the letter of credit and called for payment under the documentary credit. After recognition and support of the independence principle the court held that the independence principle ends where fraud starts. Therefore a distinction was made between a situation where there is a controversy concerning a mere breach of certain warranties or conditions and the case where the seller intentionally failed to ship the purchased goods. Thus, ‘the principal of the

¹¹³ See: Bertrams, p. 353

¹¹⁴ Bertrams, p. 349; Gao, p. 39; Westphalen, Bankgarantie, p. 406

¹¹⁵ [1941] 31 NYS 2d 631

¹¹⁶ Australia: *Inflatable Toy Co Pty Ltd v State Bank of New South Wales*, [1994] 34 NSWLR 243 (249); Canada: *Bank of Nova Scotia v Angelica-Whitewear*, [1981] 126 DLR 3d 62 (HC); South Africa: *Philips v Standard Bank of South Africa Ltd*, 1985 (3) SA 301 (W); UK: *R D Harbottle (Mercantile) Ltd v. National Westminster Bank*, [1977] 2 All ER 862 (870) (QB); *Edward Owen Engineering v Barclays Bank International*, [1978] 1 All ER 976, *United City Merchants Investments Ltd v The Royal Bank of Canada*, [1979] 1 Lloyd's Rep 276, *Bolivinter Oil SA v Chase Manhattan Bank*, [1984] 1 Lloyd's Rep 251

¹¹⁷ [1941] 31 NYS 2d 631 (633)

independence of the bank's obligation to under the letter of credit should not be extended to protect the unscrupulous seller'¹¹⁸. The *Sztejn* judgement is held to be of material importance as it firstly constituted the key elements of the fraud rule: First, payment under a letter of credit may only be interrupted in the case of fraud; mere allegation of breach of warranty cannot justify such an interruption. Second, payment can be refused when fraud is proven or established; mere allegation cannot justify such an interruption. Third, the intentional failure to perform its obligations under the underlying contract, but attempting to claim payment for that obligation constitutes fraud. As *Sztejn* involved a motion whereas all the allegations of the complaint were deemed to be true, entire issues as the onus of proof and the standard of fraud were avoided.¹¹⁹

Subsequently, that the main issue the courts based their assumption of fraud on was intentional or subjective fraud on behalf of the beneficiary.¹²⁰ According to that, subsequent decisions dealt predominantly with the term of 'the unscrupulous seller or buyer' to determinate fraud.¹²¹

The more recent approach determines the objective impact of fraud to the underlying transaction as a whole,¹²² also known with respect to the topic of 'egregious fraud'.¹²³ Thereafter, fraud will justify a refusal of payment, if the 'fraud is of such an egregious nature as to vitiate the entire underlying transaction'¹²⁴. The fraud has to be so serious as to make it obviously pointless and unjust to permit the beneficiary to obtain the money, in other words: where the circumstances 'plainly' show that the contract deprives the beneficiary of even a 'colourable' right to call for the security; ...where the circumstances reveal that the beneficiary's demand has 'absolutely no basis in fact'.¹²⁵ Accordingly the revised Art. 5 UCC adopted 'material fraud' as the standard of fraud.

¹¹⁸ [1941] 31 NYS 2d 631 (634)

¹¹⁹ See: *Discount Records Ltd v Barclays Bank Ltd*, [1975] 1 All ER 1071 (1074). Although the applicant asserted facts that were similar to the *Sztejn* case, the court rejected his application on the grounds that here fraud was not established, but merely alleged.

¹²⁰ See for example: *NMC Enterprises Inc v Columbia Broadcasting System Inc*, [1974] 14 UCC Rep Serv 1427

¹²¹ See: Westphalen, Bankgarantie, p. 406 with further evidence

¹²² See: Gao, p. 78, Westphalen, Bankgarantie, p. 406 ff.

¹²³ See: Gao, p. 69

¹²⁴ *Dynamics Corporation of America v Citizens and Southern National Bank*, [1973] 356 F Supp 991, see also: *Roman Ceramics Corporation v Peoples National Bank*, [1981] 517 F Supp 526; *Intraworld Industries v Girard Trust Bank*, [1975] 461 Pa 343

¹²⁵ *Ground Air Transfer v Westate's Airlines*, [1990] 899 F.2d 1269 (1272)

(2) The United Kingdom

The English approach of “established fraud” is based on the *Sztejn* case.¹²⁶ As Lord Denning stated in *Edward Owen Engineering v Barclays Bank International*:

‘To this general principle (of independence) there is an exception in the case of what is called established or obvious fraud to the knowledge of the bank. The most illuminating case is of *Sztejn v J Henry Schroder Banking Corp.*’¹²⁷

Nevertheless English courts employ an even more restricted approach of fraud.¹²⁸ The English approach shows a striking emphasis of the guarantor’s ‘absolute and unconditional’ undertaking and an extreme reluctance of the English courts to interfere therewith.¹²⁹ The often-quoted passages underlining that assumption are the ones of Kerr J in *R D Harbottle (Mercantile) Ltd v. National Westminster Bank*:

‘It is only in exceptional cases that courts will interfere with the machinery of irrevocable obligations assumed by banks. They are the life-blood of international commerce. ... Except possibly in clear cases of fraud of which the banks have notice, the courts will leave the merchants to settle their disputes under the contracts by litigation or arbitration as available to them ... Otherwise, trust in international commerce could be irreparably damaged.’¹³⁰

More than in any other jurisdiction independent guarantees are treated the same way as documentary credits, what is probably a further reason for their rigid approach.¹³¹ With respect to the standard of fraud the meaning as dishonesty on behalf of the beneficiary is to be found.¹³² Thereafter, it may be evidence of fraud, if there was no honest belief of the beneficiary, which has called on the guarantee that the seller has been in default.¹³³ Contrary, there would be no fraud, if the beneficiary ‘has a bona fide claim to payment

¹²⁶ See: *R D Harbottle (Mercantile) Ltd v. National Westminster Bank*, [1977] 2 All ER 862 (870) (QB); *Edward Owen Engineering v Barclays Bank International*, [1978] 1 All ER 976; *United City Merchants Investments Ltd v The Royal Bank of Canada*, [1979] 1 Lloyd’s Rep 267, *Bolivinter Oil SA v Chase Manhattan Bank*, [1984] 1 Lloyd’s Rep 251

¹²⁷ *Edward Owen Engineering v Barclays Bank International*, [1978] 1 All ER 976 (981)

¹²⁸ There are only three examples where English courts granted an injunction based on the fraud exception: *Elian and Rabbath v Matsas and Matsas*, [1966] 2 Lloyd’s Rep 495; *Themehelp Ltd v West and Others*, [1996] QB 84; *Kvaerner John Brown v Midland Bank*, [1998] CLC 446

¹²⁹ See also: Gao, p. 48 f.; Westphalen, p. 420; Wallace, Hudson’s Contracts, p. 1551 f. rec.17.067 f.

¹³⁰ *R D Harbottle (Mercantile) Ltd v. National Westminster Bank*, [1977] 2 All ER 862 (870) (QB)

¹³¹ For details, see below: Chapter C I 1.

¹³² *Balfour Beatty Civil Engineering v Technical & General Guarantee Co Ltd*, [1999] 68 Con LR 180; *Kvaerner John Brown v Midland Bank*, [1998] CLC 446

¹³³ *State Trading Corporation of India Ltd v ED & F Man (Sugar) Ltd*, [1981] Com LR 235

under the underlying contract¹³⁴. Nowadays, at least it seems that also English courts rely on a more objective, but still very restrictive point of view. In *Banco Santander SA v Bayfern Ltd*¹³⁵, the matter of ‘material misrepresentation’¹³⁶ seems to have been acknowledged as standard of fraud.

(3) South Africa

South African case law on the subject is rare. If available, the courts strikingly rely on English case law,¹³⁷ which was to be expected due to historical reasons and which can be expected for the future as well.

(4) Germany

Although the German concept of fraud is embodied in the precept of good faith and thus features a completely different dogmatic background, the general approach is very similar to the abovementioned. The contract of guarantee is, like any other contract, subject to the precept of good faith (see Art. 242 of the German Civil Code (BGB)). Thereafter the beneficiary is not allowed to make use of his formal rights against his contracting partner (the bank) in an abuse or fraudulent manner. Hence, fraud constitutes a defence for the bank and justifies a refusal of payment. Again, despite the independent nature of the guarantee, it is the conduct in regard to the underlying transaction that may constitute fraud in order to justify the refusal of payment. The standard of fraud is described in similar formulas and with striking emphasis of the objective impact to the entire transaction as especially in the more recent approach in the U.S.¹³⁸. Besides bad faith and abuse as notions of fraud, fraud is considered mostly objective as for example, if a call was made without right to payment, in violation of the entire underlying contract or if the event giving rise to a right to payment in the underlying relationship¹³⁹ has not materialised.¹⁴⁰

¹³⁴ *Deutsche Rückversicherungs AG v Walbrook Insurance Co Ltd*, [1994] 4 All ER 181 (196); *Banco Santander SA v Bayfern Ltd*, (1999) QB 29 June 1999 (Transcript), p. 2; similar in the U.S.: *Intraworld Industries v Girard Trust Ban*, [1975] 461 Pa 343

¹³⁵ (1999) QB, 29 June 1999, (Transcript)

¹³⁶ See: *United City Merchants (Investments) Ltd v Royal Bank of Canada*, [1983] AC, 168 (187)

¹³⁷ See: *Philips v Standard Bank of South Africa Ltd*, 1985 (3) SA 301 (W); *Loomcraft Fabrics CC v Nedbank Ltd*, 1996 (1) SA 812 (A); *Union Carriage and Wagon Company Ltd v Nedcor Bank Ltd*, 1996 CLR 724 (W)

¹³⁸ See also: Bertrams, p. 356 who states that the current American perception of fraud does not materially differ from those in Europe.

¹³⁹ So called: Materielles Grundgeschäft

¹⁴⁰ See: BGH, WM 1985, 511 (512); BGH WM 1988, 934 (935); BGH, WM 1994, 106; BGH, WM 2002, 743; Lohmann, p. 102 ff; Mülbart, p. 49 ff, Westphalen, Bankgarantie, p. 185 ff

(5) Conclusion: ‘Guiding Principle’

The general formulas in regard to the standard of fraud display a striking similarity. With respect to the application of the fraud exception to independent guarantees, it appears – despite the uphold independence principle – that, whatever fraud may mean, it is to be determined with respect to the underlying transaction.¹⁴¹ That assumption is acknowledged in Art. 5 sec. 5 – 109 UCC as well as in Art. 19 UNCITRAL Convention, that expressly recognizes fraud in the underlying transaction as well as fraud in the documents.

As ‘guiding principle’ may be defined that a beneficiary’s demand for payment will constitute material fraud and thus, justify the bank’s refusal to pay, if it is clearly established that his demand has no conceivable basis in fact, or if there is not even a colourable right to call the security.

The finding of a ‘guiding principle’ does not mean that there is already a uniform definition or approach. It merely summarizes the elements that are in effect in all jurisdictions subject to that analysis, despite their possibly differing approach in particular.

(6) Standard of Proof

A further common aspect to be found is the approach of the standard of proof. The approach within the different jurisdictions is almost uniform. The fraud must be ‘clear and obvious’, ‘very clear established’ or ‘beyond doubt’ and it must be ‘liquid’, which means that the account party or the bank must be able to produce the evidence immediately without in-depth investigation into the underlying transaction.¹⁴² The clarity and unanimity in that respect is caused by the stringent requirements that are in effect elsewhere especially regarding interlocutory proceedings. The submitted case law very often refers to interlocutory proceedings whereas it has to be pointed out, that especially the requirements of ‘clear established’ and ‘liquid evidence’ are subject to the certain proceedings rather than a characteristic of the fraud exception itself.¹⁴³

The high threshold of proof in general and in respect to interlocutory proceedings in particular may give some reason why there are very less established and clarified decisions with respect to the standard of fraud and substantive aspects of fraud except for ‘elusive

¹⁴¹ See: Bertrams, p. 348

¹⁴² See: *R D Harbottle (Mercantile) Ltd v. National Westminster Bank*, [1977] 2 All ER 862 (QB); *Edward Owen Engineering v Barclays Bank International*, [1978] 1 All ER 976; *United City Merchants Investments Ltd v The Royal Bank of Canada*, [1979] 1 Lloyd’s Rep 267, *Bolivinter Oil SA v Chase Manhattan Bank*, [1984] 1 Lloyd’s Rep 251; BGH, WM 1985, 511; BGH, WM 1994, 106; BGH, WM 2002, 743

¹⁴³ See below 5.1 (1) and 5.2

and magic formulas’ and ‘non-committal phrases’¹⁴⁴, because these stringent thresholds weren’t met often. Thus, decisions that go beyond these formulas, after the general requirements were fulfilled, are rare.

1.2 Substantive Aspects of Fraud

Despite the fact that the courts have not extensively elaborated and clarified the substantive aspects of fraud in terms of an exact definition what kind of conduct on the part of the beneficiary and/or what specific facts relating to the underlying relationship render a call fraudulent and thus, justify the bank’s refusal of payment, following it will be attempted to define the substantive aspects of fraud on a factual basis.

(1) Fraud in the Documents

‘Fraud in the documents’ occurs in the event of forged or fraudulent documents. This type of fraud is of material importance with respect to letters of credit.¹⁴⁵ As stated above, the payment under the letter of credit depends on the submission of certain specified documents such as shipping documents, commercial invoices, packing lists, insurance documents and bills of lading. Pursuant to the doctrine of strict compliance, the submitted documents must conform to the conditions of the letter of credit exactly to obtain payment. Thus, the risk of forged and fraudulent documents is obvious. A distinction is made between documents that appear fraudulent on their face and those that do not, but there is suspicion, customer instructions or sure knowledge of fraud. It can be said, that fraud in documentary credits mostly consists in fraud in the documents, whether with false data or other false particulars. Often forged third-party documents will occur.¹⁴⁶

With respect to performance guarantees on first demand fraud in the documents is of minor importance. It was already described that the only requirement the beneficiary has to fulfil in the event of a performance guarantees on first demand fraud is the simple demand for payment or the demand accomplished by a statement of default. Accordingly, the problem of forged documents in regard to time and place of shipping, amount, quantity or quality of goods does not occur to the same extent as to letters of credit. Thus, only a few cases deal with independent guarantees and fraud in the documents. However, the problem of forged documents can occur in regard to performance guarantees on first demand, especially if the submission of a statement of default is required.¹⁴⁷

¹⁴⁴ Bertrams, p. 353

¹⁴⁵ See: Gao, p. 134 f.

¹⁴⁶ See: Bertrams, p. 392

¹⁴⁷ See above: Chapter A II. 3. 3.1

So it did in *Kvaerner John Brown v Midland Bank*¹⁴⁸ and *Balfour Beatty Civil Engineering v Technical & General Guarantee Co Ltd*¹⁴⁹. In the *Kvaerner* case the beneficiary had the contractual obligation to submit a written notice of his intent to call the guarantee. That was to be confirmed to the bank. Although he did not submit a written notice to the account party in fact, the beneficiary stated in his statement to the bank to have made the written notice. The court considered the statement to be false and thus the demand for payment to be fraudulent.

It could be argued that the reason for considering the demand fraudulent was not the false statement itself, but the fact that it indicated evidently that there was no basis in fact for the beneficiary's claim and therefore the demand was fraudulent.¹⁵⁰ That assumption may be supported by the decision in the *Balfour Beatty* case. In that case the beneficiary submitted a statement of default, but indicated in other documents that he called the guarantee because the account party was in liquidation. In that case the court considered the statement not to be false, but considered being in liquidation as an event of default.¹⁵¹ In a few other decisions the courts also did not rely on the allegation of forged documents as to be of material importance to justify a refusal of payment.¹⁵² Thus, It may be appropriate to conclude, that fraud in the documents is of minor importance with respect to the application of the fraud exception to independent guarantees. In the event a statement of default is evidently false or forged, it will be – not necessarily, but in most of the cases – also established, that there is no conceivable basis for the demand for payment. If so, the argumentation whether the demand is considered fraudulent or not, will mainly rely on the general approach as mentioned in 1.1. Hence it could be said, fraud in the documents is rather an exception to doctrine of the strict compliance in the law of letters of credit than an exception to the independence principle of demand guarantees.

However, in the event solely fraud in the documents can be proved, that circumstance will constitute fraud as well as it would in the event of a documentary credit.¹⁵³ Hence, Art. 19 sub. 1 lit. a UNCITRAL Convention as well as Art. 5 sec. 5 – 109 UCC recognise that particular type of fraud with respect to independent guarantees.

¹⁴⁸ [1998] CLC 446

¹⁴⁹ [1999] 68 Con LR 180

¹⁵⁰ See above: 1.1

¹⁵¹ [1999] 68 Con LR 180, p. 5, 9

¹⁵² See: *Emery-Waterhouse Company v Road Island Hospital Trust National Bank*, [1985] 757 F2d 399 (404); also: *Siderius Inc v Wallace Company*, [1979] 583 SW2d 852

¹⁵³ See: Bertrams, p. 391

(2) Types of Fraud in the Underlying Transaction

Subsequently particular typical situations likely to occur in the underlying transaction, which might render the beneficiary's call fraudulent, are to be determined.

(a) Completion of the Contract by the Account Party

In legal writing it is unanimously recognised that a demand for payment is fraudulent if completion by the account party of the secured obligation is established.¹⁵⁴ Art. 19 sub. 2 lit. c UNCITRAL Convention supports that assumption. In general, case law also considers a call fraudulent if the completion by the account party is established.¹⁵⁵ The serious problem on part of the account party is admittedly to prove proper performance in consideration of the stringent requirements regarding the standard of proof. Bearing in mind the high threshold to assume fraud ('no honest belief in the default of the account party', 'no fraud, if bona fide claim', 'not even a colourable right to claim', 'absolutely no basis in fact for the claim')¹⁵⁶ it becomes obvious that the account party has to adduce very clear and convincing evidence that there is at least no basis that the beneficiary's complaints are reasonable. The most appropriate evidence to be submitted by the account party would be statements and certificates from independent persons or even from the beneficiary himself proving completion of the contract.¹⁵⁷ The assessment of weight and significance of those documents in terms of proving completion of the contract continues to be very difficult to anticipate definitely. Besides the certain circumstances in the particular case there will always be a scope of evaluation as well as divergent interpretations by the deciding courts.¹⁵⁸ Thus, in the majority of cases the account party was not¹⁵⁹ and apparently will not be able to prove proper performance in an appropriate manner.

(b) Breach of Fundamental Obligations by the Beneficiary

(aa) A breach of the beneficiary's own fundamental obligations can occur in terms of non-payment of advance or instalment payments that lead to the suspending of performance by the account party. With respect to the latter the account party has to prove proper performance in regard to the certain phase of contract, in other words to prove that the amounts are due and payable, furthermore the beneficiary's failure to pay and lastly his

¹⁵⁴ See for example: Bertrams, p. 363 f., Westphalen, Bankgarantie, p. 191, 193 f., 197 f.

¹⁵⁵ See: BGH, WM 1985, 511; BGH WM 1988, 934; BGH, WM 1994, 106; BGH, WM 2002, 743

¹⁵⁶ See above: 1.1

¹⁵⁷ See: LG Frankfurt a.M., NJW 1981, 56 ff.

¹⁵⁸ See: Bertrams, p. 364

¹⁵⁹ See for example: *United Trading v Allied Arab Bank*, [1985] 2 Lloyd's Rep 554, *Siporex Trade v Banque Indosuez*, [1986] 2 Lloyd's Rep 146; BGH WM 1988, 934; BGH NJW 1989, 1480

(the account party's) entitlement to suspend performance because of that. Taking into account the stringent requirements in regard to the standard of proof again, it will be very difficult to prove fraud. However, there exists case law granting an injunction based on the beneficiary's failure to make timely payments but despite that calling on a performance guarantee.¹⁶⁰

(bb) Despite matters of non-payment, case law also recognises the possibility of fraud due to the beneficiary's breach of his own obligations in general.¹⁶¹ Considering the general approach whereas a call might be considered as fraudulent if it has no basis in fact and thus, the fraud vitiates the entire transaction, the beneficiary's misconduct must be serious and fundamental. The assessment of such serious and fundamental misconduct will have to be derived by the provisions of principal contract, especially in terms of main obligations as well as spirit and purpose of the contract in question. Hence, a conduct that constitutes such a fundamental and serious breach to justify assessing the call fraudulent, will be mostly self evident.¹⁶² The *Sztejn* case, despite referring to a letter of credit, constitutes a descriptive example of such material misconduct.

(cc) Another example of a fundamental breach of contract on part of the beneficiary that may render a demand for payment fraudulent occurs, if the beneficiary has made the performance of the account party impossible.¹⁶³ Art. 19 sub. 2 lit. d UNCITRAL Convention recognises this type of fraud as well: A demand for payment has no conceivable basis, if the 'fulfilment of the underlying obligation has clearly been prevented by wilful misconduct of the beneficiary'. Besides physical impossibility (no access), cases are imaginable where the beneficiary either fails to supply agreed raw materials, energy or labour or where he does not produce licenses or permissions as he was contractually obliged to do.¹⁶⁴

(dd) A breach of the beneficiary's obligations may also occur in the event, he fails to furnish an agreed upon security, namely a letter of credit or a guarantee in favour of the account party (seller/employer). The furnishing of a security in favour of the account party principally is a main obligation of the principal contract and a regarding failure generally entitles the account party to rescind the contract and/or to suspend performance. Thus, in most jurisdictions subject to this analysis, the failure to furnish a documentary credit constitutes a fundamental breach of contract; if the beneficiary calls on the guarantee

¹⁶⁰ *Penn State Const Inc v Cambria Savings & Loan Ass'n*, [1987] 2 UCC Rep Serv 2d 1638

¹⁶¹ *Sztejn v J Henry Schroder Banking Corp*, [1941] 31 N.Y.S.2d 631; *United Bank v Cambridge Sporting Goods*, [1976] 392 N.Y.S.2d 265; *NMC Enterprises Inc v Columbia Broadcasting Systems Inc*, [1974] 14 UCC Rep 1427

¹⁶² See: Bertrams, p. 371

¹⁶³ See: Bertrams, p. 374 with further evidence

¹⁶⁴ See: Bertrams, p. 374

despite his failure, the demand will be fraudulent.¹⁶⁵ Despite that, some according applications were dismissed in English case law. The most ‘famous’ and most arguable cases are the ones of *Edward Owen Engineering v Barclays Bank International*¹⁶⁶ and *R D Harbottle (Mercantile) Ltd v. National Westminster Bank*¹⁶⁷. Irrespective the already mentioned scope of evaluation and divergent interpretation that occur regularly, it must be concluded that, as far as English law is applicable, the failure to furnish a documentary credit does not constitute such a fundamental and serious breach of contract as to render the beneficiary’s demand for payment fraudulent.

(ee) Also, it can be a material breach of contract and rendering a demand for payment fraudulent, if the beneficiary has cancelled the contract although the account party has given no reason in fact for termination.¹⁶⁸ As in the other cases of material and fundamental breach of contract the account party will have to convince the court that there was no basis in fact for the cancellation and therefore the beneficiary’s conduct is to be considered as such a fundamental breach that it justifies the assumption of a fraudulent demand for payment.

(c) *Force Majeure* and Embargo Cases

Although the account party did not complete their obligations, a beneficiary’s demand for payment can be fraudulent, if it is established that the alleged non-competition was caused solely by *force majeure*.¹⁶⁹ A number of cases arising out of the Iranian revolution recognise that proposition as the changing circumstances made it impossible to the account party to perform its contractual obligations properly. Thus, the account parties were not in default, but the call was held fraudulent.¹⁷⁰ Similarly a call can be fraudulent in the event of non-completion due to embargos or government measures as it was recognised in *Dynamics Corporation of America v Citizens and Southern National Bank*¹⁷¹. However, there are also decisions that refused to interfere on those grounds, but held that those matters are subject to subsequent dispute resolution.¹⁷²

¹⁶⁵ See: Bertrams, p. 373 with further evidence

¹⁶⁶ [1978] 1 All ER 976

¹⁶⁷ [1974] 2 All ER 862 (QB) with respect to the first and third guarantee subject to the decision

¹⁶⁸ Trib. com. Brussels, JCB 1980, 147

¹⁶⁹ Westphalen, Bankgarantie, p. 409

¹⁷⁰ See for example: *Harris Corporation v National Iranian Radio and Television*, [1982] 691 F2d 1344; *Itek Corporation v First National Bank of Boston*, [1984] 730 F2d 19; *Touche Ross v Manufacturers Hanover*, [1982] 449 NYS 2d 125

¹⁷¹ [1973] 356 F Supp 991

¹⁷² *State Trading Corporation of India Ltd v ED & F Man (Sugar) Ltd*, [1981] Com LR 235

(d) Material Illegality

If the secured contract is illegal under the applicable law and if the law considers the particular transaction as manifestly illegal by international standards, the call on a guarantee securing those contracts will be considered fraudulent too.¹⁷³ However, this proposition is recognised only very restrictively and exceptionally and it is limited to seriously illegal transactions.¹⁷⁴

(e) Demand for not Covered Contracts and Excessive Claims

Self-evidently a demand for payment will be fraudulent, if it relates to losses or whatsoever arising out of other contracts or obligations not secured by that particular guarantee. The same applies in the event of attempting to call all outstanding guarantees for a loss originated from just one out of a series of contracts each covered by a particular guarantee.¹⁷⁵

Similarly, the call can be held fraudulent in the event the amount claimed by the beneficiary is clearly excessive to the extent that the divergence leads to the assumption that the claim has no conceivable basis in fact.¹⁷⁶ A demand can be considered as fraudulent too if it is established that the beneficiary has already received full or partial payment or obtained full or partial damages, but tough calls for payment under the guarantee.¹⁷⁷ Again, the abovementioned difficulties with respect to the standard of proof are very likely to occur in these situations.

(f) Judgement or Arbitral Award in Disfavour of the Beneficiary

Another rather obvious case of fraudulent demand occurs in the event, a judgement or arbitral award expressly declares the non-liability of the account party with respect to a dispute arising out of the secured contract or even the invalidity of that contract¹⁷⁸ as well as in the event of the dismissal of a beneficiary's claim against the account party (in regard

¹⁷³ *United City Merchants Investments Ltd v The Royal Bank of Canada*, [1981] 1 Lloyd's Rep 604 (608, 623 ff.)

¹⁷⁴ See: Bertrams, p. 380 whereas the failure of the account party to procure e.g. an export licence should not lead to his non-liability under the furnished performance guarantee as this might be one of the risks intentionally covered by the guarantee.

¹⁷⁵ See: Trib. com. Brussels, RDC 1987, 706; see also: *United Trading v Allied Arab Bank*, [1985] 2 Lloyd's Rep 554 where the court had to deal with the argument that demands were made in regard to four transactions, but only with respect to one transaction ('the billion egg contract') there would have been disputes in fact. However, the court rejected that argument finally.

¹⁷⁶ See: BGH WM 1988, 934; LG Dortmund WM 1981, 280

¹⁷⁷ Bertrams, p. 383 with further evidence

¹⁷⁸ See also: Art. 19 sub. 2 lit. b UNCITRAL Convention

to the secured contract and on the merits of the case).¹⁷⁹ Thus, an injunction may be granted in order to await the outcome of an already pending arbitral proceeding.¹⁸⁰

(g) Situations which Ordinarily do not Constitute Fraud

In contrast to the abovementioned there are some conceivable situations that could support the *prima facie* assumption of an unfair demand, but in fact do not justify the refusal to pay in terms of the fraud exception.

(aa) As mentioned above performance guarantees principally cover also warranty obligations out of the secured contract.¹⁸¹ In the event the warranty period has already expired, a demand for payment under the guarantee is not fraudulent itself, as the expiry of the contractual obligation does not automatically impact the obligation under the guarantee.¹⁸² That could be assessed contrary, if the validity duration of the guarantee equals the warranty period or in the event of an express provision in the guarantee that contains such dependence. Apparently the latter will be the exception due to the independent character of the guarantees that are subject to this analysis.

(bb) Similarly, a demand for payment under a valid guarantee is not considered fraudulent simply because of the fact that the beneficiary's cause of action against the account party is time-barred. If the validity duration of the guarantee does not equal those periods, it will indicate that this risk is intentionally covered by the guarantee and thus, those circumstances will hardly constitute a defence against payment under the guarantee on the basis of fraud.

(cc) One of the more arguable situations to be considered is the event; the account party has a clear, indisputable and liquid counterclaim against the beneficiary out of the same (secured) contract. Deemed such a counterclaim is of equal amount as the beneficiary's claim under the guarantee an according set-off (if not contractually excluded) would cease the beneficiary's claim and thus, he had no right to payment under the guarantee.¹⁸³ Principally, it seems that this point of view does not consider the purpose of the guarantee on first demand properly. The fact of existing counterclaims itself does not render a demand for payment fraudulent, especially when taking into account the liquidity function of the performance guarantee that constitutes a intended reallocation of risks. Doubtless

¹⁷⁹ OLG Brandenburg WM 2001, 732, but also see: BGH WM 2000, 2334

¹⁸⁰ Sperry v Government of Israel, [1982] 689 F2d 30

¹⁸¹ See above: Chapter A I 3. 3.2 (2)

¹⁸² See: Bertrams, p. 369 with further evidence

¹⁸³ See for example: Westphalen, Bankgarantie, p. 397 who considers a subsequent demand as possibly fraudulent

that reallocation ends where established fraud starts. But, in contrast to the abovementioned situations, the beneficiary at least has had a justified claim under the secured contract in fact and thus, a principal right for actual payment.

Ignoring that, would lead to the conclusion that the account party (by declaring set-off) is legally enabled to alter the character of the beneficiary's claim into a fraudulent one. Also, the account party should not be able to resort to set-off as means of obtaining a security for his counterclaims he does not have.¹⁸⁴ Only in the event the counterclaim as well as the set-off has been recognised finally and binding by a court or an arbitral tribunal, the beneficiary's demand for payment would have to be considered fraudulent. As mentioned above an according decision would determine binding that the beneficiary's claim does not have a conceivable basis any longer und thus, a demand for payment would be fraudulent.¹⁸⁵

1.3 Conclusion

The starting point to define the standard of fraud is the guiding principle that a beneficiary's demand for payment is fraudulent if it is clearly established that his claim has no conceivable basis under the underlying agreement. Besides fraud in the documents, which is of minor importance to performance guarantees on first demand, several situations subject to the topic of fraud in the underlying transaction have been examined. Thereafter – in express consideration of the guiding principle – a demand could be fraudulent in the event of

- a) Completion of the contract by the account party,
- b) Breach of fundamental obligations by the beneficiary
- c) Completion impossible due to *force majeure* or embargos
- d) Materially illegal transaction
- e) Demand for not covered contracts or excessive claims
- f) Judgement or arbitral award in disfavour of the beneficiary

Besides that it was shown that certain situations, in which a demand for payment appears unfair, do not constitute fraud in the abovementioned sense. So does neither the expiry of the warranty period itself nor the fact that the cause of action might be time-barred itself constitute a relating call fraudulent. Arguable is the rather theoretical question whether a demand for payment could be fraudulent in the event of a clear, indisputable and liquid counterclaim that equals or exceeds the beneficiary's claim under the guarantee.

¹⁸⁴ Bertrams, p. 386 expressly relying on *Temtex Products v Capital Bank & Trust*, [1985] 632 F Supp 816

¹⁸⁵ See above: (f)

2. Subjective Elements of the Fraud Exception

After examining the substantive elements of the standard of fraud from a predominant objective point of view, the question arises whether the application of the fraud exception requires a subjective element on the part of the beneficiary as well. Principally, fraudulent intention, negligence or at least knowledge on part of the beneficiary comes into consideration.

2.1 Intention of Fraud

As mentioned above,¹⁸⁶ a several early decisions, especially in the U.S. were based on ‘intentional fraud’. Closely connected was the term of the ‘unscrupulous seller’. Whereas some decisions expressly pronounced an ‘evil intent’¹⁸⁷ or ‘knowledge or belief’ in regard to the false representation of fact¹⁸⁸ as requirement to the application of the fraud exception, others considered ‘intentional fraud’ as additional aspect if objective matters could not be proved.¹⁸⁹ It appears that this way of argumentation found its climax in the bulk of cases due to the Iranian revolution.¹⁹⁰ The subsequent and recent American approach emphasises the severity of the effect of fraud on the transaction rather than the state of mind of the fraudster.¹⁹¹ In *Dynamics Corporation of America v Citizens and Southern National Bank*¹⁹² the court cited that ‘fraud has a broad meaning in equity (than at law) and intention to defraud or to misrepresent is not a necessary element.’¹⁹³ Ultimately, fraudulent intent does no longer take part under the revised Art. 5 sec. 5-109 UCC.

As far as English law is concerned the term of ‘dishonesty’¹⁹⁴ bore the colour of an intentional requirement in the past. The recent English approach of ‘material misrepresentation’¹⁹⁵ is partly interpreted as to give also reason for the requirement of a subjective aspect. Thereafter, the term ‘misrepresentation’ would be very closely connected to the ‘tort of deceit’ which would contain: ‘(1) knowing the representation to be false, (2) without belief in its truth; or (3) being recklessly, careless whether it be true or false.’¹⁹⁶ At that point merely assumed,¹⁹⁷ ‘misrepresentation’ in terms of English law is to

¹⁸⁶ See: II. 1. 1.1 (1)

¹⁸⁷ *American Bell International Inc v Islamic Republic of Iran*, [1979] 474 F Supp 420 (425)

¹⁸⁸ *Derry v Peek*, [1889] 14 App Cas 337 (347)

¹⁸⁹ See: *NMC Enterprises Inc v Columbia Broadcasting System Inc*, [1974] 14 UCC Rep Serv 1427

¹⁹⁰ Westphalen, p. 410

¹⁹¹ Gao, p. 78; Westphalen, p. 406 ff, 410

¹⁹² [1973] 356 F Supp 991

¹⁹³ [1973] 356 F Supp 991 (998)

¹⁹⁴ See: II. 1. 1.1 (2)

¹⁹⁵ See: II. 1. 1.1 (2)

¹⁹⁶ Jack, *Documentary Credits*, p. 266 f.

be interpreted like that, it does not mean anyway, that intention of fraud or dishonesty are required and thus, to be proven. Doubtless there is a material difference between intent on the one hand and mere knowledge und possibly being careless on the other hand. Also, there are no indications that there must be actual proof of ‘dishonest’ intentions on the part of the beneficiary.¹⁹⁸ Nowadays, it appears that is the existence of dishonesty is inferred from established facts¹⁹⁹ and pronounced rather as additional indication for fraud than as a compulsory requirement to prove or establish fraud.

That corresponds with the German approach. Although a few German decisions rely on malevolence or bad faith,²⁰⁰ a fraudulent state of mind on part of the beneficiary was never required nor was it to be proven once.²⁰¹

2.2 Negligence

If it is established that a beneficiary’s claim or demand for payment has no conceivable basis in fact, it appears that – in most of the cases – it wouldn’t be difficult to derive his negligence in that respect. However, there are also no serious indications, especially no recent case law, that there must be actual proof of negligence on part of the beneficiary.²⁰²

2.3 Knowledge

Similarly, but compared to intent or negligence constituting the lowest threshold, the aspect of the beneficiary’s knowledge is to be considered. In fact it is hardly imaginable, especially in consideration of the guiding principle, whereas the fraud exception will only apply if there is no basis for the beneficiary’s claim at all, that his demand is to be considered fraudulent, but he does not have any knowledge about his unjustified demand, but rather is in good faith. However, assumed such a case – objective fraudulent demand, but good faith – would appear, would that render his call fraudulent und justify the refusal to pay in terms of the fraud exception?

(aa) In *United City Merchants Investments Ltd v The Royal Bank of Canada*²⁰³, the court ruled, relying on the abovementioned *ex turpi cause rule*, that the fraud exception is

¹⁹⁷ See below: 2.2

¹⁹⁸ See: Bertrams, p. 348

¹⁹⁹ See for example in: *Themehelp Ltd v West and Others*, [1996] QB 84; *Kvaerner John Brown v Midland Bank*, [1998] CLC 446

²⁰⁰ See: II. 1. 1.1 (4)

²⁰¹ Bertrams, p. 342

²⁰² To the argument of Jack, *Documentary Credits*, p. 266 f. that could be understood as the requirement of negligence see below 2.3.

²⁰³ [1983] 1 AC 168

limited to any fraud the beneficiary had knowledge of. But, the case dealt with the matter of a letter of credit and of fraud by a third party, which will be examined hereafter. The striking difference is, that in the event of fraud by a third party, knowledge of fraud might be an appropriate aspect to be required in regard to the person of the beneficiary, which does not act at all.²⁰⁴ Thus, that case does not answer the above raised question.

(bb) It appears, that exactly matching case law does not exist.²⁰⁵ It might be useful to examine the currently existing rules. Art. 5 sec. 5-109 UCC solely relies on the aspect of ‘material fraud’ in consideration of its impact on the entire transaction. Neither Art. 5 sec. 5-109 UCC nor its official comment suggest that the beneficiary’s subjective element is required nor has to be proved.²⁰⁶ The same is to be ascertained by reviewing Art. 19 sub. 1 and 2 UNCITRAL Convention. The provisions do not contain subjective requirements at all. Despite that, it could be argued that these certain objective elements, especially considering terms like ‘not even a colourable right’ or ‘no conceivable basis’, necessarily imply that the beneficiary has at least knowledge of the facts that render his demand fraudulent. That is an argument similar to the abovementioned interpretation of the English ‘material misrepresentation’. Agreeing that facts that render a demand for payment fraudulent (in consideration of the guiding principle) indeed have to be of such weight and importance, it justifies the implication and conclusion that the beneficiary has to have at least knowledge of the facts. Hence, it seems to be appropriate to admit ‘good faith’ or actual unawareness on the part of the seller as reason that can hinder the application of the fraud exception if an appreciation of values would determine an impact to the objective requirements such as ‘no conceivable basis for demand’. Hence, ‘good faith’ or unawareness would have to be alleged and proved as a defence against the exception by the beneficiary.

(cc) Inversely, the high standard of fraud in regard to the guiding principle also justifies the ‘reverse-conclusion’, that – if the objective requirements are met – it will ordinarily indicate the beneficiary’s knowledge of the relevant facts. Furthermore, there are no indications, neither in the mentioned rules nor in recent case law that the account party would have to assert and prove the beneficiary’s knowledge. That applies a fortiori with respect to negligence. The argument, whereas the English ‘misrepresentation’ is closed to the ‘tort of deceit’ and thus, besides knowledge, it would have to be required that the beneficiary does not believe in the truth or is recklessly careless whether true or false²⁰⁷ is a mere terminological argument. It cannot be supported by relating provisions or by case

²⁰⁴ See below 3. 3.1 (2)

²⁰⁵ In *G.K.N. Contractors Ltd v Lloyd’s Bank Plc*, [1985] 30 BLR 53 (63) the fraud exception applied despite the beneficiary’s demand being in good faith, but on the reason the bank was justified aware of invalidity.

²⁰⁶ See: Gao, p. 85

²⁰⁷ See: Jack, Documentary Credits, p. 266 f.

law. And most important, it was displayed that the purpose of the fraud exception, relying on material and obvious objective facts (offering at least a chance to be proved in proceedings of interlocutory injunctions) does not require the additional proof of a subjective element of the beneficiary.

2.4 Conclusion

It can be summarized that today neither fraudulent intent, nor negligence, nor actual knowledge on part of the beneficiary is required or to be proven within the U.S. and German law. With respect to English and thus, possibly also to South African law, it is not absolutely clear if the recent standard of fraud, namely the ‘material misrepresentation’ requires a subjective element. If so, it seems to be limited to matters of knowledge rather than to those of negligence or intent.

In the event of an objective fraudulent call, but established and proven good faith of the beneficiary, a defence against the application of the fraud exception could be acknowledged with good reasons. As that case constitutes again an exception, the beneficiary would have to establish and prove his good faith.

3. Parties to the Fraud

3.1 Identity of the Fraudulent Party

(1) Fraud by the Beneficiary

The classic case of fraud in regard to a performance guarantee is the fraud by the beneficiary himself, rendering his demand for payment and possibly stating the account party would be in default in order to obtain payment by the guarantor. The conduct and/or circumstances that render the beneficiary’s demand fraudulent were described in detail.²⁰⁸

(2) Fraud by third Parties

Besides that, fraud by third parties is conceivable. Generally, third party’s fraud is more likely to occur with respect to commercial letters of credit than to performance guarantees.

²⁰⁸ See above 1., 2.

(a) Minor Importance with Respect to Performance Guarantees

The trite reason for the minor importance with respect to performance guarantees is, that neither third parties themselves nor documents by third parties are required within the usual payment mechanism of performance guarantees on first demand. The only formal requirement for payment is ordinarily a written demand, possibly accomplished by a statement of default. Hence, the problem of required (and possible forged) documents or statements of third parties (transporters, sub-deliverers, insurances etc.) do not arise to the same extent as to commercial letters of credit. Notwithstanding that, a brief overview to the question of third parties fraud might be useful as it provides a further example of the manifold problems to the fraud exception and their partly controversial solution. The term 'fraud by third parties' refers to cases, where the fraudulent party is neither legally connected to the beneficiary nor is its conduct generally attributable to the beneficiary on legal grounds.²⁰⁹ Thus, the question arises whether the fraud exception applies despite that.

(b) The Leading Case

The leading case with respect to fraud by third parties is *United City Merchants Investments Ltd v The Royal Bank of Canada*²¹⁰ that dealt with a letter of credit. An English company sold glass fibre making equipment to a Peruvian company, payment was to be made by a letter of credit. The English company assigned their rights to *United City Merchants*. The goods were actually shipped on 16 December; required was the 15 December. The bill of lading, to be submitted in order to obtain payment under the letter of credit was dated 15 December. It appeared that an employee of the loading broker fraudulently altered the date in the bill of lading without knowledge of the seller and consignees of the letter of credit. As the buyer and his bank refused payment, *United City Merchants* brought the action against them. The case was decided by the Queen's Bench Division, by the Court of Appeal and by the House of Lords.

The trial court denied the application of the fraud exception. Relying on *ex turpi causa* rule, the court did not assess fraud on part of the beneficiary and therefore rejected the defendant's contention.²¹¹ Contrary the Court of Appeal relied solely on the matter of the authenticity of the documents to be submitted: 'The identity of the forger is immaterial. It is the fact that the documents are worthless that matters to the bank.'²¹² Accordingly the fraud exception applied. Finally, the Houses of Lords unanimously overruled the decision

²⁰⁹ In the event, the third person acted for example as agent for the other party see: *HIH Casualty and General Insurance Ltd v Chase Manhattan Bank*, [2003] 2 Lloyd's Rep 61 (74 f.)

²¹⁰ [1979] 1 Lloyd's Rep 267 (QB); [1981] 1 Lloyd's Rep 604; [1983] 1 AC 168

²¹¹ [1979] 1 Lloyd's Rep 267 (268)

²¹² [1981] 1 Lloyd's Rep 604 (632)

of the Court of Appeal and decided, that fraud of third parties justify the application of the fraud exception (to the uphold independence principle), only if the beneficiary had actual knowledge in regard to the untrue representation. That condition would have to be drawn out of the underlying maxim of *ex turpi causa non oritur actio*.²¹³

Although not finally applied, the general possibility of a third party's fraud in terms of a 'material misrepresentation' was acknowledged, subject to actual or constructive knowledge of the beneficiary. The decisions of the trial court and especially the House of Lords were often criticized, especially with respect to the 'not ideal result'²¹⁴ and the drawn conclusion that the beneficiary was not responsible for the authenticity of the submitted documents.²¹⁵ Expressly disregarding the matter and the weight of the forgery of documents, the knowledge of the beneficiary appears to be appropriate to be required in regard to the person of the beneficiary that does not act at all. It appears to be one of the lowest possible thresholds to be required in the event of fraud by third parties that are not connected to the beneficiary. Considering the importance and weight of the forged documents, one could argue that due to their material impact on the entire transaction, the beneficiary must at least have had knowledge although he didn't forge the document by himself. In contrast to the situation examined above (if solely the beneficiary acts in terms of submitting a statement of default and demanding payment),²¹⁶ it appears much more difficult to draw this conclusion in the event of third party's fraud, which conduct is not attributable to the beneficiary on legal grounds. However, when reviewing solely Art. 19 UNCITRAL Convention or Art. 5 sec. 5-109 UCC, it could also be argued that also in the event of third party's fraud knowledge on part of the beneficiary is not expressly required. Assuming that, it would again appear to be appropriate accepting the beneficiary's statement and evidence of good faith,²¹⁷ in particular the lack of actual knowledge of the third party's fraud as possible defence to the fraud exception. However, with respect to English courts – although relying nowadays on 'established misrepresentation' as primarily objective aspect – the requirement of the beneficiary's knowledge in the event of fraud by a third party is still in effect. Thus, the account party would have to assert and prove the beneficiary's knowledge.

Despite that, it can be said, that with respect to objective aspects of the standard of fraud there are no significant differences to fraud by the beneficiary himself, especially the guiding principle will have to be considered as well. Thus, the objective aspects such as

²¹³ [1983] 1 AC, 168 (183 f.)

²¹⁴ Gao, p. 129

²¹⁵ See for example: Arora, (1981) 2 Co Law 66 (66 f.); Cansler, (1982) 17 Texas Int'l LJ 229 (240 ff.); Goode. [1980] JBL 291 (294)

²¹⁶ See above: 2. 2.3

²¹⁷ See above: 2. 2.3

‘material fraud’, ‘material misrepresentation’, ‘no colourable right’ or ‘no conceivable basis’ should be of vital importance when assessing the application of the fraud exception in the event of third parties fraud as well.

3.2 Identity of Defrauded Party

One could raise the question, which requirements are to be fulfilled in regard to the defrauded party. It appears to have some potential of conflict, as the beneficiary normally will demand payment from the bank stating the account party was in default. The usual procedure would be payment by the bank. But, disregarding matters of established fraud and according knowledge thereof, the bank generally has a claim for reimbursement against the account party. In the event of fraud the beneficiary feints the bank stating untrue facts about the beneficiary and, if fraud was not established or the bank had no knowledge, the damage will occur on part of the account party, as he will be liable for reimbursement generally. Again, disregarding details whether a loss could be assumed on part of the bank (e.g. risk of reimbursement), this situation is known as ‘triangle fraud’ in criminal law. Thereafter the assumption of fraud can be made only in the event of a close natural, economical, or legal relation between the feinted party, that initiates the fraudster’s monetary advantage due to a valid action (payment), and the party to whom the loss incurred finally.

However, such a distinction is expressly not made with respect to the application of the fraud exception. The trite reason is that the fraud exception as defined and understood nowadays does not have much in common with fraud in terms of criminal law. Again and thus, supporting the aforementioned assumptions, the material impact of the fraudulent behaviour on the entire transaction is of importance. Necessary, but sufficient to apply the fraud exception is that a call has no conceivable basis in fact, no matter to whom the statement was submitted nor to whom the loss has incurred. Hence, both remaining parties, directly involved in the guarantee, namely the bank and the account party are potential and ‘suitable’ defrauded parties.

4. The Guarantor’s Knowledge

So far the matter of the guarantor’s actual knowledge of the beneficiary’s fraud was intentionally abstracted away from the standard of fraud for reasons of clarity. Notwithstanding, that is a question of material importance and in fact it bears serious difficulties for the account party to convince the guarantor, mostly a bank, with respect to the beneficiary’s fraud in an appropriate way in order to restrain the bank from payment to the beneficiary. Though it can be said that the banks’ practice in regard to payment refusals

on the grounds of (alleged) fraud is of restrictive nature, it must not be concluded that the bank always adopts an uncooperative attitude. However, it always to be considered that a bank has to bear in mind its contractual obligations towards both the beneficiary and the account party and the bank is not a court.

4.1 The Acknowledged Principle

Case law²¹⁸ and legal writing²¹⁹ in all relating jurisdictions unanimously recognise that the bank should refuse payment in the event the beneficiary's fraud is evident to the bank at the time of intended paying or passing on demand. Only if that is clearly the case, the bank has a duty arising out of the guarantee's contract to the account party to refrain from payment. If it neglects that duty, the bank will be held liable. Primarily the bank would then forfeit its right of reimbursement. With respect to German law the bank's responsibility arises out its ancillary duty with respect to the guarantee's contract to carry out the mandate's contract in good faith and with due care.²²⁰

The aforementioned principle thus contains two main elements. Firstly, if fraud is evident to the bank, generally it will have to refrain from payment. That element relates to the period before payment and thus is material especially for the granting of interlocutory restraining orders against banks. It can be said that this element of the principle constitutes a cause of action against the bank.²²¹

The second element refers to the bank's liability, in the event of proceeding payment, although fraud was or must have been evident to the bank, in other words: if the bank has had actual or constructive knowledge. Whereas the consequences out of the principle differ with respect to the distinction between 'before' and 'after payment', the requirements remain the same: At the time of passing on demand or intended payment, the bank must have had actual or constructive knowledge of the beneficiary's fraud. Due to the different consequences, the question whether the bank had the required knowledge will ordinarily occur with respect to proceedings in regard to the bank's liability, namely in proceedings

²¹⁸ See for example: *United City Merchants Investments Ltd v The Royal Bank of Canada*, [1983] 1 AC 168; *R D Harbottle (Mercantile) Ltd v. National Westminster Bank*, [1977] 2 All ER 862 (870) (QB); *Edward Owen Engineering v Barclays Bank International*, [1978] 1 All ER 976; *United Trading v Allied Arab Bank* [1985] 2 Lloyd's Rep 554; *Deutsche Rückversicherungs AG v Walbrook Insurance Co Ltd*, [1994] 4 All ER 181; LG Dortmund WM 1981, 280; LG Frankfurt a.M., NJW 1981, 56

²¹⁹ See for example: Bertrams, p. 395 ff.; Mülbart, p. 113 ff.; Wallace, Hudson's Contracts, p. 1551 rec. 17-067; Westphalen, Bankgarantie, p. 358 ff., 389

²²⁰ See for example: LG Dortmund WM 1981, 280; LG Frankfurt a.M., NJW 1981, 56

²²¹ See: Bertrams, p. 396

to gain re-payment after the bank has already debited the customer's account or as defence against the bank's seeking of reimbursement.²²²

4.2 The Practical Approach

(1) Case Law and Legal Writing

As unanimously as the abovementioned principle is recognised, a bulk of case law and legal writing is to be found, pronouncing that the bank's contractual duty not to pay, if fraud is established, does not imply or constitute the bank's duty to investigate or to initiate actions to determinate the alleged fraud. The statements spread from general determinations that the bank is not concerned with the underlying transaction in general or with dispute of opinion between the parties (beneficiary and account party) to more specific findings whereas there is simply no bank's duty to enquire the beneficiary's demand or the account party's allegations, but the account party's interest and thus, responsibility to produce irrefutable evidence of fraud in clear and doubtless manner.²²³ Due to the reallocation of risks constituted by the independent guarantee it is the account party's concern and risk to deal with the beneficiary's fraud and the regarding evidence thereof. The aforementioned principle neither intent nor in fact does countervail that allocation of risks.²²⁴

(2) Justification

The reasons for that kind of approach are manifold. First, as already stated the bank is neither a court nor an investigator nor does it have the required recourses to act like one of them. Second, the bank has contractual obligations and duties to both the beneficiary and the account party. Even if the account party is held to be worthy of protection, the bank can't be expected to unduly delay payment once the (formal) conditions of the guarantee have been met.²²⁵ Third, although critics of case law in favour of banks and credit institutions are common and popular, the bank's worthiness of protection in order to maintain their capacity to act and perform their obligations properly can't be ignored

²²² The question whether the proof of the bank's knowledge is required in interlocutory proceedings will be examined hereafter, see below 5.2 (1) (b)

²²³ See for example: *R D Harbottle (Mercantile) Ltd v. National Westminster Bank*, [1977] 2 All ER 862 (870) (QB); *Edward Owen Engineering v Barclays Bank International*, [1978] 1 All ER 976 (983, 985 f.); *Bolivinter Oil SA v Chase Manhattan Bank*, [1984] 1 Lloyd's Rep 251 (257); *United Trading v Allied Arab Bank*, [1985] 2 Lloyd's Rep 554 (561); *Tukan Timber v Barclays Bank*, [1987] 1 Lloyd's Rep 171 (175); *Türkiye İs Bankası v Bank of China*, [1999] 2 Lloyd's Rep 611 (617); BGH WM 1996, 2228; OLG München WM 1988, 1554 or Mülbert, p. 99 f., Westphalen, Bankgarantie, p 196 ff., 206, 247 f.

²²⁴ See: Bertrams, p. 398 with further evidence

²²⁵ See: Westphalen, Bankgarantie, p. 206, 248

seriously. Fourth, the account party's ordinary recourse must remain to procure an interlocutory restraining order by the court as the unique competent body.

Accordingly, Art. 19 and 20 UNCITRAL Convention as well as Art. 5 sec. 5-109 sub. a (2) UCC do not constitute an unconditional duty of the bank to refuse payment in the event of established fraud, but state that the issuer (bank), acting in good faith, may honour or dishonour a request for payment (Art. 5 sec. 5-109 sub. a (2) UCC) or provide the bank's right (not the duty) to withhold payment while acting in good faith (Art. 19 sub. 1 UNCITRAL Convention).

4.3 Particular Requirements of the Guarantor's Knowledge – The Test

As with every subjective or mental condition, evidence can only be derived from objective facts. These facts have to be of such weight and quality to enable the deciding courts inferring actual or constructive knowledge of the bank at the time of payment.

It is self-evident that it matches the interest of the account party to put conceivable evidence in front of the bank in order to produce the required grade of knowledge on part of the bank. It is submitted that the evidence must have been clear and obvious such that the only realistic inference to draw for the bank was fraud,²²⁶ in other words: the ordinary, prudent and diligent bank must have been convinced that the beneficiary's demand was fraudulent. That constitutes a very high threshold to be met by the account party's evidence and thus, courts have been very reluctant to assume that, on the strength of the material before the bank, it must have had knowledge of the beneficiary's fraud. Nonetheless there is also a remaining risk on part of the bank regarding the scope of evaluation the courts will acknowledge in case of relating disputes.

4.4 Modification

Considering the ambivalence of the abovementioned arguments the 'alternative set of rules' recommended by *Bertrams*²²⁷ seem to provide a more even-handedly, but tough appropriate and legitimate solution. Thereafter the bank shall not be liable to the account party in cases of alleged fraud if it notifies the account party of the beneficiary's demand for payment and subsequently postpones payment for an appropriate short period (a few days), should the account party furnish plausible evidence of fraud. The interval allows the

²²⁶ *United Trading v Allied Arab Bank*, [1985] 2 Lloyd's Rep 554 (561); *Csarnikow-Rionda v Standard Bank*, [1999] 2 Lloyd's Rep 187 (197, 202 ff.); *Turkiye Is Bankasi v Bank of China*, [1999] 2 Lloyd's Rep 611 (617)

²²⁷ See: *Bertrams*, p. 400 f.

account party to pursue interlocutory proceedings in order to prevent payment on the basis of a court decision. In the event the account party does not apply for such an order in the meantime, the bank shall be entitled to proceed payment. That procedure bears the advantage that it can neither be argued that fraud has been evident (if the account party does not initiate interlocutory proceedings) nor conflicts that short interval with the bank's obligations in regard to the beneficiary. Furthermore, the party whose interest the refusal of payment matches (the account party), is to take initiative and the competent body (the court) is to decide whether fraud has been established appropriate. The bank gets the opportunity not to conflict with one of two the parties it has obligations to fulfil.²²⁸ These recommendations are possibly inferred from and thus, consistent with the rules set out in Art. 5 sec. 5-109 sub. a (2) and b UCC and Art. 19, 20 UNCITRAL Convention; both provide interaction between the bank's right (not duty) for refusal of payment on the one, and the account party's according right to obtain restraining order against the bank and/or beneficiary if fraud was evident, on the other hand.

It could be argued, that this 'additional set of rules'²²⁹ may lead to a contraction of the account party's rights as his time-frame for the assertion of his rights is predefined and thus, restricted. Assumed that constitutes interference in fact, it is countervailed and thus, legitimated by the advantage he obtains due to the interval of non-payment by the bank. In order to achieve that, the threshold of a plausible furnishing of evidence is significantly lower than with respect to the acknowledged rule and to the standard of proof his allegations will have to meet in subsequent interlocutory court proceedings.

As long as these modifications aren't recognised or acknowledged by case law and legal writing, it is at least conceivable, to recommend the incorporation on a contractual basis. Notwithstanding the fact that their validity with respect to the different applicable laws that can occur in international trade could not be taken for granted, it would serve to establish and strengthen the legal certainty with respect to the parties to the contract. It would at least constitute a guideline for acting, that – even if held invalid – does not bear material risks (the bank does not breach obligations to one of both parties and the account party does not forfeits his rights), but offers several opportunities to resolve arising disputes.

5. *Procedural Background and Relating Standard of Proof*

It was already mentioned that the issue of the fraud might arise in two different main settings. One setting is that the account party raises fraud as defence after the bank already

²²⁸ See: Bertrams, p. 401

²²⁹ 'Additional set of rules' might be the more appropriate term as 'alternative' implies a substitution or exception from the aforementioned acknowledged rule, which is not the fact.

paid the beneficiary and now claims reimbursement or similarly, the account party raises fraud as cause of action when claiming re-payment from the bank and/or the beneficiary after the bank has already paid the beneficiary and debt the accounts of its customer.

The other possibility is to raise fraud as defence and/or cause of action in interlocutory proceedings against the bank and/or the beneficiary seeking to provide payment and thus, applying for an injunction against one or both of them.

Although the preventive actions within interlocutory proceedings should take place before repressive actions of defending reimbursement or claiming re-payment, the latter will be examined first as it represents the normal or ordinary procedure. Thereafter, the specialities and features of interlocutory proceedings will be shown.

5.1 Repressive Legal Actions after Payment

(1) Defence Against the Bank's Claim for Reimbursement

The normal procedure after having made payment to the beneficiary is the bank's claim for reimbursement against their customer, the account party. Ordinarily, just the event of payment entitles the bank for reimbursement, implying that the terms of condition for payment were met. Thus, the beneficiary would have to show and prove that the requirements of the fraud exception were met, in other words that the bank breached its ancillary duty not to pay because of established fraud.

(aa) As examined before, the account party has to furnish convincing, clear and doubtless evidence that the beneficiary's conduct constitutes an acknowledged case of the fraud exception as it matches the standard of fraud in the certain jurisdiction.²³⁰ With respect to the standard of proof there are generally no further requirements than in any other legal action. To point it out again, the often mentioned and underlined requirement of liquid evidence refers to interlocutory proceedings exceptionally.²³¹

(bb) Besides that, it was also already mentioned²³² that in the event, the bank already paid the beneficiary, it is generally necessary to prove that the bank had actual knowledge of the fraud at the time of payment, in other words that the beneficiary's fraud have been or must have been evident to the bank. The evidence to be submitted by the account party must be clear and obvious such as that the only realistic conclusion to draw for the bank

²³⁰ See for objective and subjective requirement above: 1.-3.

²³¹ See below: 5.1

²³² See above: 4.

was fraud.²³³ The ordinary, prudent and diligent bank must have been convinced that the beneficiary's demand was fraudulent. Repeating it again, even within the ordinary repressive court proceedings to defend a bank's claim for reimbursement, the threshold to be met by the account party's evidence, is significantly high. Accordingly, courts have been very reluctant to assume that the bank must have had knowledge of the beneficiary's fraud.

(2) Cause of Action in a Claim for Re-payment or Damages

(a) Claim Against the Bank

In the event the account party claims re-payment or damages after the bank has made payment to the beneficiary and debited the account party's accounts, the evidence to be procured remains almost the same as in the event of defending a bank's claim for reimbursement. Besides a case of established fraud, the account party has to prove the bank's breach of ancillary duty, which is only possible, if the account party can show that the bank had or must have had actual knowledge of the beneficiary's fraudulent demand.

It seems to be useful, to describe the factual difficulties the account party will have to face in the event of legal actions against the bank after payments to the beneficiary besides the already mentioned legal difficulties. Firstly, in very majority of cases, the bank will be entitled to debit the customer's account immediately after payment under the guarantee, which often results in an uncomfortable situation and liquidity problems for the account party. Secondly, to initiate legal proceedings against a bank, especially for damages (which means there is no urgency on the part of the bank), will constitute a real financial, legal and factual challenge for customers, especially if they are not used to be called 'big players'. Third, even in the event of a successful claim against the bank, it would lead to the peculiar and dissatisfying result, that the loss now occurs on part of the bank, but the fraudster is (theoretically) still in possession of the received payment.

(b) Claim Against the Beneficiary

Generally, the account party has the possibility to claim damages for the loss that incurred due to the reimbursement by the bank, if he didn't succeed with a claim against the bank. The obvious advantage is that the account party won't have to prove actual knowledge of the bank. According to the findings above, the account party also does not have to prove

²³³ See above: 4.3

knowledge or any other subjective element on the part of the beneficiary.²³⁴ In principal, it would also comply with the idea of ‘pay first, argue later’ and the reallocation of risks established in the performance guarantee. Nonetheless, claims against the beneficiary bear several legal and factual difficulties for the account party. Besides possible claims out of the principal contract, legal difficulties appear mainly with respect to the particular situation and involvement of at least three parties. As the beneficiary will have received the payment by the bank, the cause of action will have to match the requirement for an unjust enrichment. To examine the particular requirements subject to the different jurisdictions in question would go beyond the limited scope of that analysis, but it can be anticipated that it bears some material difficulties. Even more than that, the account party will face factual difficulties to receive payment from the fraudulent beneficiary in terms of likelihood of insolvency or bankruptcy on the part of the beneficiary rather than on the part of a bank. Also several other factual obstacles, for example changing political circumstances in foreign jurisdictions are more likely to occur with respect to the certain beneficiary.

5.2 Interlocutory Proceedings before Payment

Considering the aforementioned manifold problems that can occur in repressive legal actions after payment, it becomes obvious that the majority of case law in regard to the fraud exception refers to interlocutory proceedings²³⁵ in which the account party applies for an injunction restraining either the bank from proceeding payment (1) or the beneficiary from demanding payment (2) under the guarantee in question.

In principal, these interlocutory proceedings serve to avoid factual and difficult to be rescinded results (caused by the payment) that would lead to unreasonable harm of the account party in the event of payment. They are interlocutory or provisional in the sense that the decision can be set-aside in subsequent main proceedings. Due to their urgent character the means of evidence are restricted in most jurisdictions. Especially there won't be witness examinations. Witness statements in form of affidavits substitute that. In English and American law injunctions can be made even without the defendant's knowledge and participation, so called *ex parte* injunctions. In German law the defendant must have received a notice of the application made by the account party and accordingly must have been given an opportunity to defend himself in terms of at least submitting a statement. In English and American law, *ex parte* injunctions will be followed by *inter partes* hearings immediately. In German law the applicant may apply for proceedings without (oral) hearings subject to the urgency of the case. In that event the proceedings will contain the submission of written statements only.

²³⁴ See above: 3.

²³⁵ Also known as provisional, interim, preliminary proceedings or einstweilige Verfügung

In general a successful application for a restraining order in interlocutory proceedings requires the substantial likelihood of success in the merits. Thus, it is necessary to procure clear, obvious and liquid evidence of the beneficiary's fraud²³⁶ as these proceedings neither allow nor serve lengthy and in-depth investigations in terms of hearings, expert witnesses or whatsoever. With respect to performance guarantees the main purpose of interlocutory proceedings also have to comply and generally not to interfere with the initial purpose of the guarantee in terms of its liquidity function to serve as immediate financial compensation once the terms and conditions for payment have been met.

(1) Interlocutory Proceedings Against the Bank

Besides the aforementioned general aspects, some particular requirements have to be fulfilled in prospect of success. As the account party tries to reach a restraining order against the bank, he must base his application on a cause of action against the bank. The cause could only be the bank's (imminent) breach of its ancillary duties out of the guarantee contract, concrete: to restrain from payment, if the beneficiary's fraud is evident.²³⁷ Thus, one element to be proven in a clear, obvious and liquid manner is the fraud by the beneficiary, which will mainly refer to objective elements.²³⁸

(a) Knowledge by the Bank?

It was also examined, that the bank's knowledge of the beneficiary's fraud was to be proven in the event of defending a claim for reimbursement by the bank or in the event of claiming re-payment from the bank;²³⁹ both situations in which the bank has already paid despite their (alleged) knowledge. Now the question appears, if relating evidence is necessary in the event, the account party tries to prevent payment by the bank. That question is answered differently within the reviewed jurisdictions.

Whereas neither American nor German²⁴⁰ (case) law (as well as most of the other European laws²⁴¹) requires evidence of the bank's knowledge in interlocutory proceedings, English law does.²⁴² Despite that 'firmly established'²⁴³ requirement of the bank's

²³⁶ See above: 1. 1 (6)

²³⁷ See above: 1., 4.

²³⁸ See above: 1.1, 2

²³⁹ See above: 4., 5.1 (1)

²⁴⁰ See for example: LG Dortmund WM 1981, 280; OLG Frankfurt a.M. WM 1983, 575, slightly different: LG Frankfurt a.M., NJW 1981, 56 that referred to the bank's knowledge, but without having a significant impact on the decision

²⁴¹ See: Bertrams, p. 414 with further evidence

²⁴² See for example: *United Trading v Allied Arab Bank*, [1985] 2 Lloyd's Rep 554 (561); *Csarnikow-Rionda v Standard Bank*, [1999] 2 Lloyd's Rep 187 (197, 202 ff.)

²⁴³ See: Bertrams, p. 409

knowledge in English law an argument raised by the Philips J in *Deutsche Rückversicherungs AG v Walbrook Insurance Co Ltd* matches the problem of the bank's knowledge in relation to interlocutory proceedings precisely: 'Once the proceedings have reached the inter partes stage...the evidence of fraud will be placed simultaneously before the court and before the bank...If the court concludes that there is clear evidence of fraud, it will necessarily conclude that the bank has (now) acquired knowledge of the fraud.'²⁴⁴ One could conclude that according to that, evidence regarding knowledge of fraud is not an additional threshold.²⁴⁵ Irrespectively calling it an additional threshold or not, it seems, that once fraud is clearly established and proven, it should not be difficult to deprive according knowledge on part of a bank which is party to the interlocutory proceedings. Thus, in the event of established fraud, evidence in respect to the knowledge of the bank is mostly not required. If so, it can be derived from the circumstance that the court considers a conduct as fraudulent within courts proceedings the bank is party to.

(b) Balance of Convenience Test and Irreparable Harm

(aa) In almost all reviewed jurisdictions the granting of a restraining order against the bank is subject to the passing of the so called 'balance of convenience test'. That test tries to maintain the balance between the unconditional obligation of the bank under an independent guarantee on the one hand and the worthiness of protection of the account party on the other hand by appreciation of concerning values and interests. That test, whether called like that or not, is to be found in England, the U.S. and in Germany. In general it is the assessment of values of whether the injury of the account party, if the injunction were rejected, would outweigh the harm which granting would inflict on the bank. Thus, the test contains the two main considerations. First, will damages be an appropriate and sufficient remedy, if the application for an injunction is rejected and second, does the grant of injunction probably do more harm than its refusal.

(bb) Especially the English and the more recent German approach²⁴⁶ appears to be very restrictive. With respect to the first argument it seems that both, English and nowadays also German courts consider the account party's ordinary possibility to claim damages after the bank's payment as aspect to militate the balance of convenience test in disfavour of the account party. The German approach of 'lack of interest' on part of the account party due to the possibility of claiming damages is thus extended to the point that the bank's payment

²⁴⁴ [1994] 4 All ER 181 (195)

²⁴⁵ So: Bertrams, p. 409

²⁴⁶ Before the decisions of the appeal courts in OLG Frankfurt a.M. WM 1988, 1480; OLG Köln RIW 1992, 145; OLG Düsseldorf ZIP 1999, 1518, German case law favoured the possibility of restraining orders against the bank: LG Dortmund WM 1981, 280; LG Frankfurt a.M., NJW 1981, 56; OLG Frankfurt a.M. WM 1983, 575

in the face of established fraud results in a cause of action that is limited to the bank's forfeiting its right of reimbursement.²⁴⁷ Similarly, the court in *R D Harbottle (Mercantile) Ltd v National Westminster Bank* ruled that the account party seeking an interlocutory injunction will have to face what seems to be an 'insuperable difficulty',²⁴⁸ the balance of convenience test. Kerr J stated that even in the event of (assumed) established fraud and knowledge on the part of the bank, a restraining injunction would still be inappropriate as the account party would have an adequate remedy against the bank in damages.²⁴⁹ With respect to the consideration of possible (further) harm caused by the issuing of an injunction especially English courts again strikingly emphasize the (unwritten) policy not to interfere with the bank's unconditional obligation to pay under an independent guarantee referring to the argument of 'life blood' of commerce in that respect²⁵⁰ as well to the bank's reputation²⁵¹ and its discretionary power to decide whether to pay or not, irrespective from its liability to the account party.

(cc) Art. 5 sec. 5-109 UCC in the U.S. contains the 'balance of convenience test' and the additional requirement of 'substantial threat of irreparable harm' to the account party. As the first is also understood as the assessment of values as mentioned before, the latter expressly asks for a possible injury of the account party in the event the injunction is not issued, considering the fact whether the account party is able to effectively recover his loss. In general the American approach is also rather restrictive, but it appears to be more flexible. Especially with respect to the cases caused by the Iranian revolution the courts granted the injunction considering the account party's difficulties or even their impossibility to recover their losses in ordinary legal actions.²⁵²

(dd) It can be summarized that the possibility of a restraining order against the bank due to the beneficiary's fraudulent call is generally acknowledged in every jurisdiction subject to that analysis. Due to the approach the courts exercise with respect to the 'balance of inconvenience test', the likelihood of success in practice appears very little elsewhere.

(ee) Considering the difficulties the account party has to face in regard to repressive legal actions,²⁵³ that result gives reason for criticism. Firstly, when assessing the possibility of subsequent claim for re-payment or defense against reimbursement as aspect to militate

²⁴⁷ OLG Frankfurt a.M. WM 1988, 1480; OLG Köln RIW 1992, 145; OLG Düsseldorf ZIP 1999, 1518

²⁴⁸ [1977] 2 All ER 862 (869)

²⁴⁹ [1977] 2 All ER 862 (869)

²⁵⁰ See: *R D Harbottle (Mercantile) Ltd v National Westminster Bank*, [1977] 2 All ER 862 (870); *Csarnikow-Rionda v Standard Bank*, [1999] 2 Lloyd's Rep 187 (197, 202 ff.)

²⁵¹ See: *Tukan Timber v Barclays Bank*, [1987] 1 Lloyd's Rep 171 (174)

²⁵² See: *Itek Corporation v First National Bank of Boston*, [1984] 730 F2d 19; *Harris Corporation v National Iranian Radio and Television*, [1982] 691 F2d 1344; *American Bell International Inc v Islamic Republic of Iran*, [1979] 474 F Supp 420;

²⁵³ See above: 5.1

the balance test in disfavour of the account party, the material difficulties, especially with respect to the evidence of the bank's knowledge must be taken into account. It appears not be so. Secondly, the current approach does not recognize the factual position of the bank adequately, namely the possibility to debit the customer's accounts when generally rejecting restraining orders. Thirdly, the bank's standing and reputation in regard to the beneficiary seems to receive more weight than the bank's reputation with respect to their customer, although the obligations should be of equal importance to maintain the bank's neutrality. Furthermore, it would not harm a bank's reputation, if the courts decide to restrain from payment, because of established fraud. Fourthly, the reluctance of the courts to interfere countervails the bank's neutrality as the bank is forced to decide whether the facts in front of it justify the restraining from payment or not. Fifthly, it seems not to be convincing, to assess the balance test by just generally referring to the purpose of independent guarantees with the 'life blood' argument, as it finds its border where fraud is established. Considering the high threshold to the standard of fraud and proof, there is no need to render restraining orders against banks factually impossible. Finally, there is no doubt that the granting of restraining orders is the most effective means of preventing fraud at all. Especially when taking into account that even if the account party succeeds in terms of defending reimbursement or claiming re-payment, the appearance of loss will just shift to the bank, but the fraudster would still be in possession of the received payment.

(2) Interlocutory Proceedings Against the Beneficiary

Lastly the granting of an interlocutory injunction to restrain the beneficiary from demanding or receiving payment is to be considered. There are no significant differences with respect to the standard of fraud. It must be proven in a clear, established and liquid manner.

As those proceedings would take place between the account party and the beneficiary, it becomes obvious that even if English law were applicable, it would not be necessary to procure evidence with respect to the knowledge of the bank. Besides that, proceedings against the beneficiary might be more promising, as the balance of convenience test might not have the same outcome as within the proceedings against the bank. Generally, the courts emphasize that the stringent requirements in respect to the evidence of fraud are the same in both procedures (against the bank as well as against the beneficiary) and 'the effect on the life blood of commerce will be precisely the same whether the bank is restrained from payment or the beneficiary is restrained from asking payment.'²⁵⁴ But it

²⁵⁴ *Group Josi v Walbrook Insurance Co Ltd*, [1996] 1 Lloyd's Rep 345 (361); see also: *Deutsche Rückversicherungs AG v Walbrook Insurance Co Ltd*, [1994] 4 All ER 181 (196 f); *Csarnikow-Rionda v Standard Bank*, [1999] 2 Lloyd's Rep 187 (202)

appears to be at least arguable, to assess the account party's possibility to raise fraud as defence against the bank's claim for reimbursement or the account party's claim for repayment (again, both with the additional requirement to prove the bank's knowledge) when considering the balance of convenience test in favour of the evidently fraudulent beneficiary. Furthermore, proceedings against the beneficiary bear the advantage that the proceedings are addressed to the 'right', namely the allegedly fraudulent, party. Also, the proceedings will predominantly have to deal with the beneficiary's (and not the bank's) conduct and they will predominantly affect the beneficiary's position. In conclusion, applications for restraining orders against both the beneficiary and the bank appear to be the better and more promising procedure.²⁵⁵

III. SUMMARY

In all reviewed jurisdictions the fraud exception and its requirements are described in general formulas rather than as concrete definition what kind of conduct on the part of the beneficiary and/or what specific facts relating to the underlying relationship render a call fraudulent and thus, justify the bank's refusal of payment. Despite differences in detail, the general approach of the standard of fraud and the standard of proof displays striking similarities with respect to the standard of fraud as well as to the standard of proof. Hence, a 'guiding principle' was defined: At least a beneficiary's demand for payment will constitute material fraud and thus, justify the bank's refusal to pay, if it is clearly established that his demand has no conceivable basis in fact, or if there is not even a colourable right to call the security.

When applying the fraud exception, judiciary especially in English and American law does not distinguish between letters of credit and performance guarantees. With respect to the latter, it seems to be recognized though that fraud will predominantly occur in the underlying transaction. Besides that, fraud may also occur as fraud in the documents. Both Art. 5 sec. 5-109 UCP and Art. 19 UNCITRAL Convention, acknowledge the possible occurrence of these types of fraud in respect to independent guarantees.

With respect to the subjective elements of the fraud exception, it was determined that fraudulent intent or negligence on part of the beneficiary is not required generally. But, good faith on part of the beneficiary may constitute a defence against the fraud exception. In the event of fraud by third parties, which are not legally connected to the demanding beneficiary, the knowledge of the latter is required. It can be argued, whether the account party has to prove the beneficiary's knowledge – so the English approach – or the

²⁵⁵ See also: Bertrams, p. 419 f.

beneficiary has to prove his good faith – so the more modern approach, considering the objective focus set out in Art. 5 sec. 5-109 UCC and Art. 19 UNCITRAL Convention.

In contrast, the bank's knowledge of the beneficiary's fraudulent demand is principally necessary, namely in the event of repressive legal actions after the bank has proceeded payment. If the bank had actual knowledge of the established fraud by the beneficiary, the proceeding of payment constitutes a breach of the bank's ancillary duties out of the guarantee contract. Then the bank would not be entitled to debit their customer's accounts or the account party may claim damages. The regarding evidence to be procured by the account party must be clear and obvious such that the only realistic conclusion to draw for the bank was fraud. It could be displayed, that it will be very difficult to meet that very high threshold and that courts accordingly have been very reluctant to assume that the bank must have had knowledge of the beneficiary's fraud.

Finally, the two main procedural situations in which the fraud exception might be raised were determined. With respect to both, repressive legal actions and interlocutory proceedings the standard of proof in respect of the fraudulent demand must be 'clear and obvious', 'beyond doubt' and 'established'. These terms are used almost unanimously and uniformly.

Repressive legal action against the bank or the beneficiary in order to defend reimbursement or to claim damages bear several difficulties for the account party. Besides the factual situation (ordinarily the bank will debit the accounts immediately after having proceeded payment), it appears to be almost impossible to prove of the aforementioned bank's actual knowledge.

Hence, it was concluded that interlocutory proceedings are of material importance as the granting of restraining orders (to restrain from payment or to restrain from asking for payment) are the most effective means of preventing fraud. But, the prospect of success appears to be minimal. Besides additional requirements regarding 'liquid' evidence, meaning that the procured evidence must be likely to convince the court without in-depth investigation, the so called 'balance of convenience' test applies elsewhere. Because of the account party's possibility to raise the fraud exception as defence against a bank's claim for reimbursement or as cause of action for damages in the event the bank has proceeded payment and debit his accounts in subsequent normal proceedings, the courts assess the test usually in disfavour of the account party. It was emphasized that this constitutes an unsatisfactory legal position for the account party as well as for the bank. Recommendations for another approach were given. Also it was pointed out, that the test in interlocutory proceedings against the beneficiary could be appreciated in another way for

good reasons. Thus, it appeared to be at least more promising for the account party to initiate interlocutory proceedings against both, the bank and the beneficiary.

CHAPTER C: CONCLUSION

I. GENERAL

The review of the fraud exception in Chapter B already focused on performance guarantees. It appeared that, despite the more objective standard of fraud, especially English and American law made no serious distinction between letters of credit and performance guarantees. Thus, the question arises, if the particular approach should be equal or even more restrictive than the one that applies to letters of credit, or – in contrast thereto – if a less restrictive approach appears is favourable.²⁵⁶

II. EQUAL OR MORE RESTRICTIVE APPROACH

1. Case Law

The current legal position, expressed in American and English case law appears to favour an equal or even more restrictive approach of the fraud exception to performance guarantees.²⁵⁷

The first major case to be referred to is *R D Harbottle (Mercantile) Ltd v. National Westminster Bank*²⁵⁸. When examining the fraud exception, the court described the very exceptional character of a court's interfering, without further justification, 'in the case of a confirmed performance guarantee, just as in the case of a confirmed letter of credit' and went on emphasizing the 'unqualified terms' not providing 'any safeguard' of performance guarantees on first demand to the extent that those guarantees would seem 'astonishing, but being by no means unusual.'²⁵⁹ The court's view might be represented by the following statement quite most descriptive:

'In this case the plaintiffs took the risk of the unconditional wording of the guarantees. The machinery and commitments of banks are on a different level.

²⁵⁶ So: Bertrams, p. 392; Schmitthoff, JBL 1977, 351 (353); Wallace, Hudson's Contracts, p. 1553 rec. 17-070 f.

²⁵⁷ See: Bertrams, p. 391 f.; Wallace, Hudson's Contracts, p. 1553 rec. 17-070 f.

²⁵⁸ [1977] 2 All ER 862 (QB)

²⁵⁹ [1977] 2 All ER 862 (864 f)

They must be allowed to be honoured, free from interference by the courts. Otherwise, trust in international commerce could be irreparably damaged.²⁶⁰

When considering the standard of established fraud the court referred to cases dealing with letters of credit, amending – again without any justification – that the authorities concerned with letters of credit would equally apply to performance guarantees.²⁶¹

Subsequently the court in *Edward Owen Engineering v Barclays Bank International*²⁶² referred to the provision made in the aforementioned case, but examined the relation of performance guarantees and letters of credit in respect to the fraud exception more closely. Thereafter, performance guarantees would have many similarities to letters of credit. With respect to the fraud exception at least the same approach as to letters of credit would have to be applied, in the words of the court: ‘the performance guarantee stands on a similar footing to a letter of credit’²⁶³. The court even held, that considering the wide wording, the waiver of proof of default and the fact that a performance guarantee covers (just) between 5 and 10 per cent of the contract price, it rather appears to be ‘liquidated damages’ or a ‘penalty’ and thus bears the colour of a discount on the price of 5 or 10 per cent.²⁶⁴ Similarly, the bank’s independent obligation to pay under both, a letter of credit and a performance guarantee, were emphasized in *Howe Richardson Scale Co Ltd v Polimex-Cekop and Westminster National Bank Ltd*²⁶⁵, as was the similar treatment of a (performance) bond and a letter of credit in *Balfour Beatty Civil Engineering v Technical & General Guarantee Co Ltd*²⁶⁶ and *Bolivinter Oil SA v Chase Manhattan Bank*²⁶⁷.

It must be pointed out that the courts in the aforementioned cases refused to acknowledge ‘established fraud’ and thus, the conclusion that the fraud exception will apply to performance guarantees in the same way as to letters of credit, might be rather a general statement than the result of a concrete determination. That assumption can be supported by the court’s recurrent argument of the assumed negative impact of court’s interfering in general.²⁶⁸

²⁶⁰ [1977] 2 All ER 862 (870)

²⁶¹ [1977] 2 All ER 862 (870)

²⁶² [1978] 1 All ER 976

²⁶³ [1978] 1 All ER 976 (983)

²⁶⁴ [1978] 1 All ER 976 (982)

²⁶⁵ [1978] 1 Lloyd’s Rep 161 (165)

²⁶⁶ [1999] 68 Con LR 180, p. 9

²⁶⁷ [1984] 1 Lloyd’s Rep 251; see also: *Howe Richardson Scale Co Ltd v Polimex-Cekop and Westminster National Bank Ltd*, [1978] Lloyd’s Rep 161 (165)

²⁶⁸ See for example: *R D Harbottle (Mercantile) Ltd v. National Westminster Bank*, [1977] 2 All ER 862 (870); *Edward Owen Engineering v Barclays Bank International*, [1978] 1 All ER 976 (983)

The 'equal approach' as exercised within the reviewed jurisdictions appears to performance guarantees to the extent determined in Chapter B. That means in particular: the high material and procedural threshold with respect to 'established fraud' in the underlying transaction, as far as English law is concerned the requirement of a subjective aspect on part of the beneficiary, the necessity to prove the bank's knowledge of fraud in 'after-payment' cases and the unilateral assessment within interlocutory proceedings against the bank, especially regarding the balance of convenience test.

2. Justification?

The main reason, to apply the fraud exception to performance guarantees in same way as to letters of credit appears to be that the securities are conceptually similar. Both are independent securities. Thus, the uphold principle of independence applies and interference by courts shall remain the absolute exception. According to the reasoning in the decisions above, one could conclude that the impact on the 'life blood of commerce' due to interfering courts would be generally of same weight and strength as a characteristic of both securities is the bank's unconditional undertaking.

According to the remarks especially in the *Harbottle* and the *Edward Owen* case, it appears that the courts assume the account party of a performance guarantee on first demand is even less worthy of protection and thus, a even more rigid approach would be justified. Due to the lack of any safeguards in the terms and provisions of the guarantee, the account party has almost to expect that there will be unjustified calls by the beneficiary. That must be concluded when the court explains that a performance guarantee bears the colour of 'liquidated damages' or a 'penalty'.

One could argue that this assumption also complies with the principle of 'pay first, argue later' and the concerning reallocation of risks constituted by the guarantee. Furthermore that approach might maintain the liquidity function of the performance guarantee on first demand most properly; especially when considering the account party's possibility to defend reimbursement and/or claim damages after a court refused to interfere and the bank has proceeded payment – without taking into account the manifold legal and factual difficulties that have to be faced in that event. Accordingly one could argue that it appears reasonable that it is more difficult for an account party to a performance guarantee to prove established fraud in the underlying transaction than for an account party to a letter of credit to prove the forgery of a document.

II. REASONS FOR A LESS RESTRICTIVE APPROACH

It appears very arguable that the reasons mentioned above justify the application of the fraud exception to performance guarantees on first demand in an equal or even more restrictive way as to letters of credit. When examining the aforementioned arguments more closely, the opposite, namely a less restrictive approach, appears to be favourable as the protection of the account party to a performance guarantee under the current approach of the fraud exception seems inappropriate.

1. The 'similar' Purpose of the Securities

While accepting that the overall purpose of a performance guarantee and a letter of credit, namely to provide security in the event the contract party fails to perform their obligations, is at least similar, it is not equal. The concrete purpose differs significantly, especially in respect to the likeliness of the occurrence of fraud.

A letter of credit might be plainly described as a substitute of payment. In the event of proper performance the seller has to prove the fulfillment of his obligations in order to obtain the substitute of payment, the payment under the letter of credit. Ordinarily the atmosphere between seller and buyer at that stage of transaction is still pleasant. Furthermore, the guarantor expects the call for the security as it forms part of the regular transaction. If the calling for a security is part of the transaction, the guarantor ordinarily must not be especially aware of a fraudulent call as it is part of the regular procedure and fraud is generally less likely to occur than in a situation a dispute has already arisen.

But, exactly this is the situation, wherein a performance guarantee might be called. The performance guarantee is designed as a default instrument to provide financial compensation in the event of non-performance. Thus, it will be exercised in the event a dispute has already arisen. It is obvious that within a tense atmosphere between the contract parties the temptation to call an existing and valid security unjustifiably appears to be more likely. Hence, the account party to a performance guarantee faces the risk of a fraudulent call to the same, or even to a greater extent than the account party to a letter of credit.

2. The Different Payment Mechanism und the Guarantors Limited Duty of Examination

It was already mentioned that payment mechanism as well as concerning requirements differing significantly. Whereas the beneficiary of a letter of credit has to submit certain specified documents²⁶⁹, the beneficiary of a performance guarantee just has to demand payment and possibly submit a statement of demand.²⁷⁰ Despite the fact that fraud in the documents is less likely to occur with respect to performance guarantees, it can be concluded that the threshold to demand payment in respect to a letter of credit is obviously higher. Considering furthermore that the principle of strict compliance that is (to a protecting extent) only in effect to letters of credit, the level of protection of performance guarantees is significantly lower.²⁷¹

3. The Principle of Independence

Whereas fraud with respect to letters of credit ordinarily appears as fraud in the documents, fraud with respect to performance guarantees is to be determined in regard to the underlying transaction. Although the latter is recognized as type of fraud in all reviewed jurisdictions, the account party faces much more difficulties to prove that kind of ‘established fraud’ than an account party to a letter of credit, that ‘just’ has to prove the forgery of a document. Besides the manifold difficulties, which were determined in Chapter B, there is another trite reason for that imbalance of protection: Although the fraud exception is almost unanimously described as exception to the principle of independence, with respect to letters of credit as well as to performance guarantees, it appears to be the exception to the independence principle only with respect to the latter.²⁷² It was determined that the courts, although recognizing that type of fraud as exception in general, are very reluctant to interfere with the bank’s unconditional undertaking for reasons occurring out of the underlying transaction.

In the event of a forged document, required by a letter of credit, the application of the fraud exception does not constitute an exception from the principle of independence. It is rather an exception from the principle of strict compliance. With respect to that, it appears that courts have not been as reluctant to interfere in the event of the forgery of a document. The reason might be that it is not necessary to investigate the underlying transaction.

²⁶⁹ See above: Chapter B II. 1. 1.2 (1)

²⁷⁰ See above: Chapter A II 3. 3.1

²⁷¹ See above: Chapter A II 4.

²⁷² See: Bertrams, p. 392

That leads to the unsatisfying conclusion, that letters of credit and performance guarantees are said to be treated generally the same way, but due to the characteristics of each security and the courts greater reluctance to interfere with the independence principle than with the principle of strict compliance, the level of protection with respect to performance guarantees is again significantly lower.

4. The Alleged Negative Impact on the 'Life Blood of Commerce'

Besides the tendency to uphold the independence principle for dogmatic reasons, it has been shown that a very recurrent argument is the asserted negative impact on the 'life blood of commerce' if the courts would interfere with the bank's unconditional undertaking under independent guarantees such as letters of credit and performance guarantees. Besides that concerns about the bank's international standing and reputation are expressed constantly.²⁷³

Again, the equal treatment or better the equal concern in respect to letters of credit as well as to performance guarantees appears to be inappropriate. Relating to the different purpose of both securities, it must be distinguished. The payment under a letter of credit can be assumed as part of the regular transaction and thus, it can be expected in the majority of cases. Contrary the payment under a performance guarantee intentionally will take place only in the 'irregular' event of the account party's default. If English courts emphasize the safeguarding of letters of credit and the reputation of banks in honouring such documents, the parallel to performance guarantees is not self-evident.²⁷⁴ Despite the liquidity function of the latter, it is not a substitute for payment. It is a default instrument. How should the machinery of commerce in general, or the reputation of a bank in particular suffer harm, if fraud would be established in court proceedings and thus a restraining order would be granted? If concerns about the machinery of commerce, including the effectiveness of securities and default mechanisms are to be taken into account, it must meet the interests of international commerce or of the banking community as a whole as well, to protect all involved parties from misuse and fraud²⁷⁵ and from situations, in which banks have to act like courts. With respect to American courts, that generally seem less reluctant to intervene, it can neither be concluded that this would have resulted in commercial dislocation²⁷⁶ nor that American banks would have a worse reputation or international standing than English ones.

²⁷³ See: *Bolivinter Oil SA v Chase Manhattan Bank*, [1984] 1 Lloyd's Rep 251 (256)

²⁷⁴ See: Wallace, *Hudson's Contracts*, p. 1553 rec. 17-070 f.

²⁷⁵ See: *United Trading v Allied Arab Bank*, [1985] 2 Lloyd's Rep 554 (561); *Tukan Timber v Barclays Bank*, [1987] 1 Lloyd's Rep 171 (175)

²⁷⁶ See: *United Trading v Allied Arab Bank*, [1985] 2 Lloyd's Rep 554 (561)

5. *Is the Account Party to a Performance Guarantee Less Worthy of Legal Protection?*

After examining predominantly the current legal and factual position, the following could be illustrated: Firstly, letters of credit and performance guarantee contain major legal and factual differences. Secondly, these differences form the basis for the assumption, that the account party to a performance guarantee faces a significant lower level of protection due the characteristics of the security. Thirdly, the asserted negative impact on machinery of commerce, in the event of interference because of established fraud under a performance guarantee cannot be approved. Fourthly, the current approach, examined in Chapter B., whether called ‘equal’ or not, leads to a minor level of protection compared with the legal situation of an account party to a letter of credit. After all, the question arises, is that imbalance of protection justified, in other words: Is the account party to a performance guarantee less worthy of legal protection?

One could argue that the account party to a performance guarantee must know about his lack of protection when agreeing upon performance guarantees on first demand and it is not on the courts to outweigh this due to an adequate or slightly different approach of the fraud exception.

That might be the view especially English courts take.²⁷⁷ It appears that this point of view still contains some material scepticism in respect to performance guarantees on first demand, which might be described with the plain phrase: ‘You made your bed, now you must lay in it.’

One argument against, which is of more factual than legal nature, is that the ordinary seller or employer will not have a real choice to agree upon a performance guarantee on first demand if he wants or has to compete on international markets. Thus, the legal worthiness of the court’s advise in *Edward Owen Engineering v Barclays Bank International*²⁷⁸, whereas the seller, ‘if he is wise’ will take the possibility of an unjust demand for payment into account when quoting his price for the contract, might at least be arguable.²⁷⁹

Irrespective if the aforementioned scepticism is still adequate (at least doubtful with respect to the general acknowledgment of performance guarantees on first demand), it seems to be the wrong conclusion to limit the less protection of the account party. While accepting that a party that agrees upon a performance guarantee in international trade has

²⁷⁷ See above I.

²⁷⁸ [1978] 1 All ER 976

²⁷⁹ See: *Edward Owen Engineering v Barclays Bank International*, [1978] 1 All ER 976 (982)

to be aware of the risks it enters into and thus have to accept a lower level of protection due to the nature of the guarantee, it cannot be concluded that the account party to a performance guarantee is less worthy of protection than the account party to a letter of credit. It appears reasonable to require a high objective threshold constituting which conduct and/or circumstances render a call fraudulent. But, the possibilities to prove such circumstances in a procedural frame must remain possible.

That means the approach of the standard of fraud, examined in Chapter B. II. 1.- 4., appears to be reasonable and adequate. Taking also into consideration that alleging fraud is very common to prevent payment. In contrast, the procedural difficulties the account party has to face, especially with respect to the unilateral assessing of the balance of convenience test appear inappropriate. The plain argument of an alleged 'equal' approach does not justify the in so far unjust and unacceptable imbalance of legal protection as there are significant differences. On the other hand these characteristics do not constitute a lack of worthiness of protection of the account party to a performance guarantee. Neither its liquidity function nor the alleged impact on commercial mechanisms would justify that the account party has to accept an obvious and material fraudulent demand for payment.

III. RECOMMENDATIONS

Finally it will be expressed again what particular approach of the fraud exception in the event of performance guarantees is favourable and thus, to recommend.

1. Standard of Fraud

The recent or modern approach that was determined and defined in Chapter B. II. 1, containing the requirement of material fraud, namely the fact that a beneficiary's demand is fraudulent if there is no conceivable basis in fact, to be determined by objective aspects and circumstances – predominantly resulting from the underlying transaction – is indeed reasonable and appropriate. The provisions set out in Art. 5 sec. 5-109 UCC and Art. 19 UNCITRAL Convention represent guidelines that should be followed when applying the fraud exception to performance guarantees on first demand in international trade. The provisions as well as the 'guiding principle' constitute a high objective threshold. It allows maintaining the exceptional character of the fraud rule by acknowledging the purpose of a performance guarantee on first demand. In concrete it recognizes its liquidity function and the reallocation of risks constituted by the guarantee. On the other hand it constitutes a minimum level of protection against unjust and fraudulent demand for payment, if the particular application considers the objective focus, which was tried to set out.

Accordingly fraudulent intent or negligence on part of the beneficiary of a performance guarantee should neither be required nor to be proven by the account party. Except cases of third parties fraud, the same should apply to the aspect of actual knowledge on part of the beneficiary. As explained in Chapter B. II. 2.3 the occurrence of good faith on part of the beneficiary should constitute a defence to be raised and proven by the beneficiary, which may – depending on the particular facts of the case in question – hinder the application of the fraud exception. The latter should remain the common consequence in the event of established, objective fraud.

The difficulties the account party faces with respect to the third objective requirement, the actual knowledge of the bank, were examined in detail. As a matter of fact the proof of subjective aspects will always bear material problems. It is neither possible nor favourable to abandon this aspect in the event of ‘after-payment’ cases. Nevertheless, the analysis showed that an ‘alternative set of rules’ generally based on the provisions of Art. 5 sec. 5-109 UCC and Art. 19 UNCITRAL Convention and expressed by *Bertrams* appeared to be useful, but are not acknowledged until now. Thereafter, a fixed procedure for the parties involved could be determined, how to handle situations in which the allegation of fraud appears practically and neutrally. Another possibility to increase the level of protection of the account party in that respect is a changing approach within interlocutory proceedings.²⁸⁰

2. Standard of Proof

In general the high threshold in respect to the standard of proof is reasonable, considering the value of maintaining the purpose und thus, the functioning of performance guarantees on first demand as effective and secure default instrument in international trade. Hence, the acknowledged requirements of ‘clear’, ‘obvious’, ‘beyond doubt’ or – with respect to interlocutory proceedings – ‘liquid’ evidence don’t give cause for criticism.

3. Procedural Approach

The most crucial aspect to constitute an appropriate level of protection for an account party to a performance guarantee is the prospect of success in interlocutory proceedings. Interlocutory restraining orders are the most effective means in order to prevent fraudulent demanding. Thus, it may protect not only the account party, but also the bank, the machinery of commerce and the legal relations. In contrast to that theoretical opportunity, the current approach in almost all reviewed jurisdictions is unsatisfactory. The unilateral

²⁸⁰ See below: 3.

assessment of the 'balance of convenience' test in disfavour of the account party underestimates the factual and legal difficulties to be faced in after payment proceedings against the bank and the beneficiary. With respect to proceedings against the bank matters like the proof of the bank's knowledge and the factual position of the bank must be assessed as well. Also the general consequences of the determined reluctance to interfere have to be taken into account, namely that banks are forced to act and assess like courts. That, in the event of payment and (unlike) success in after payment proceedings against the bank, the assumed fraudster may keep in possession of payment and the loss incurring will simply shift to the bank. Also, that the machinery of commerce might be influenced much worse by the appearance of fraud and de facto unprotected account parties than by interfering courts basing their decisions on well balanced and reasonable standards of fraud and proof. Furthermore, the provisional character of an injunction must be emphasized. Thus, the alleged danger of negative impact on the machinery of commerce seems to be overestimated. Lastly, it must be considered that in the event of performance guarantees the current approach in that respect leads the institute of the fraud exceptions as well as the regarding standards almost *ad absurdum* as the factual level of protection does not reflect its theoretical extent.

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