

THE FRAUD EXCEPTION IN BANK GUARANTEE

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I hereby declare that I have read and understood the regulations for the submissions of LLM dissertations, including those relating to length and plagiarism, as contained in the rules of the University and this dissertation conforms to those rules.

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DEDICATION

I take pleasure in dedicating this dissertation to my parents, Mr. and Mrs. KAYEMBE.

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Every accomplishment in life is a result of the contribution of many individuals who both directly and indirectly share their gifts, talents with us all. This dissertation is no exception.

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INTRODUCTION

General

Independent bank guarantees or standby letters of credit are relatively recent developments which are encountered primarily in international supply or construction contracts. It seems that they first appeared in the American domestic market some time in the mid-1960s but according to bankers' information they acquired a significant position in the international banking only at the beginning of the 1970s.¹ The increasing wealth in the oil-producing countries of the Middle East in this period enabled these countries to enter into a large number of contracts with the western countries with a view to the development of infrastructure in industrial, agrarian, and social fields, as well as national security. The origin and development of independent bank guarantees and especially of demand guarantees at an initial stage is related with this event.²

Bank guarantees are widespread and the scope of their usage is very increasing. It could be said with confidence that all major international economic transactions are conducted with at least some kind of bank guarantee. Furthermore, they are also commonly used in contracts within national borders. This swift growth is related with the possibility to use bank guarantees as back up to all kinds of transactions, both non-financial and purely financial obligations. Indeed, they are frequently used as security for default in connection with contracts for supply of goods, construction and shipbuilding contracts, mergers and acquisitions, technology transfers, as well as to secure obligations resulting from loans, leases, bond issues, commercial paper and other financial transactions. In addition, bank guarantees can provide security to both the party which is entitled to payment and the party which is entitled to receive goods or services³. For instance, in an

¹ R Bertrams, *Bank Guarantees in international trade*, 3rd ed., Kluwer law international, (2004), at 1.

² Paatakhotenashvili, 'Some aspects of Bank (Independent) Guarantees according to national legislation and private international law', 6/2003-2/3, *Georgian law review*, at 329.

³ R Bertrams, *op.cit.*, at 2.

international contract of sale a bank guarantee can be issued in favor of the buyer who wishes to insure against the seller being unable to supply the goods sold or /and in favor of the seller who wishes to insure against the failure of the buyer to pay the purchase price or meet his other obligations under the contract of sale.

In international trade the risk factor acquires more and more awareness and importance. Indeed, nowadays transactions tend to be very complex as a result of global expansion and thus they involve large amount of money. In order to mitigate risks of non-payment, devices such as letters of credit and collateral acceptance of drafts have been introduced. Bank practice has been accustomed to these instruments for a long period of time. However, these traditional means of risk mitigation revealed themselves to be sometimes cumbersome and inefficient, particularly when it comes to the fulfillment of non-financial obligations. In order to solve the pitfalls encountered with the traditional means of security, the independent bank guarantee was invented. It is mainly issued by reliable and sustainable institutions such as banks. The independent guarantee operates in much the same way as documentary credits. Consequently despite their differences,⁴ both instruments share many similar characteristics such as the rule of independence, the principle of payment of the sum only in the case of fulfillment of the terms and conditions of the guarantee, and the rule of strict compliance.

The structure of independent guarantees allows for various mechanism of payment. The type that has attracted the greatest attention is the guarantee payable upon first demand, also called unconditional guarantee. It entitles the beneficiary to receive payment from the bank without any proof or corroboration of the principal debtor/exporter's

⁴ An important difference between documentary credits and independent guarantees can be found in their payment function. The documentary credit constitutes a normal mode of payment; the bank guarantee however serves as a security device. Accordingly, an independent guarantee can only be used if a risk occurs that is covered by that guarantee. The parties do not expect that the risk will materialize and the party that furnishes the guarantee hope that it will never be used. In short, while payment under the letter of credit is the normal course under the execution of the contract, a payment under an independent guarantee is the exception.

default.⁵ Although, commonly used it should be noted that first demand guarantees are not the only type of payment, the parties may also agree that payment be made only upon presentation of documents that prove the debtor default (this kind of payment is referred to as conditional guarantee) or on submission of a court judgment or an arbitral award.

First demand guarantees are capable of being easily abused, as the beneficiary does not need to prove a violation of the contract or the suffering of damage or any other risk against which the guarantee was to provide protection. The problem of unfair or abusive calling is of considerable importance in international practice as this may amount to fraud. It is important to bear in mind that fraud is virtually the only defense in order to escape payment under a demand guarantee. Over the years, a huge volume of cases in many countries have been brought up before the courts where a party to an international transaction has complained that the other party has used the guarantee contrary to its purpose i.e. trying to collect money in an unjustified or fraudulent way. However only a very small minority of cases has been pleaded successfully. This may be explained by the lack of uniformity in the understanding of what really constitutes fraud.

The situation in case of unfair calling is very interesting, as it results to a conflict of interest. On the one hand, the principal who is often exposed to the risk of unfair calling wants to have a legal safeguard built into the legal obligation of the guarantor; and on the other hand beneficiaries and banks are of the view that payment should be made on the basis of a formal check of the written demand.⁶ The uncertainty created by such situation is an enormous disadvantage on the count of bank guarantee as it undermines significantly its liquidity function which is the core of all bank guarantees.

Whether such instrument maintains the enormous popularity that it enjoys with overseas buyers as well as bankers will depend largely upon the attitude of the courts, and in

⁵ R Bertrams, *op.cit*, at 3.

⁶ N Horn, *German banking law and practice in international perspective*, Walter de Gruyter, 1999, at 194.

particular their willingness to enforce contractual undertakings according to their terms. Three questions are therefore worth to be asked: First, does fraud require deceitful or malicious conduct on the part of the beneficiary? Secondly, is fraud to be determined by having regard to the underlying relationship or is it restricted to fraudulent acts within the confine of the contract of guarantee? Finally, what is the standard of proof of fraud?⁷ Until now, courts' decisions rely on case-by-case analysis, and such an analysis does not lend to generalization. The lack of generalization has resulted in a proliferation of bank guarantee's litigations and in costly uncertainty throughout the bank guarantee world. If an internationally uniform approach to the resolution of unfair calling and fraud can be found, this would mean important progress in the development of international commercial law.

Terminology

To understand the essence of bank guarantee, it is necessary to have clear idea about the terms and definitions that are used in relation with this instrument in various legal source- in national and private international law.

Guarantee= Independent guarantee

Theoreticians and practitioners recognized that the terminology and the concept of guarantees are, or at least were marked by confusion, uncertainty, and inconsistency. The adoption of English and American terminology by Continental banking practice also contributed to the confusion. However, for the purpose of this study it should be noted from the outset that the term guarantee means "independent guarantee", as opposed to the accessory or conditional guarantee.

The modern independent guarantee originated from practice, and the concept, as it functions today, was unknown in law. After, some initial confusion, Continental law reserves the term guarantee for the concept of independent guarantee, while the term

⁷ R Bertrams, op.cit., at 259.

“suretyship” refers to the accessory type but practice uses the term “guarantee” for both independent guarantee and suretyship.⁸

This study avoids the term “bond” even though some authors think that it is another form or word to mean demand guarantee.⁹ In countries such as the United States and Canada, insurance companies rather than banks issue performance bonds. The performance bond should never be assimilated to demand guarantee, as they are very different. Indeed, the performance bonds are a hybrid form of security and they cannot be circumscribed to the terms of independence. Furthermore, contrary to independent guarantees, performance bonds are never payable on demand.

Standby letter of credit= Independent guarantee

There is a widespread belief that American standby letters of credit are different from the European independent guarantee. This is a fallacy. The function and mechanics of standby letters of credit are indisputably the same as those of independent guarantees.¹⁰

Two factors contributed to the emergence and use of the American standby letter of credit. Nationally chartered banks in the United States are prohibited by Federal and State banking laws from acting as guarantors or sureties for the obligations of third parties. The issuing of such guarantees was considered *ultra vires* and was believed to be the sole area of insurance and bonding companies. Therefore, performance type guarantees have become the business of an entirely separate industry, the surety bond industry. This industry is heavily regulated in the United States by the insurance commissioners, and consequently has always been very conservative in both its underwriting policies and geographical scope.¹¹ The prohibition on bank guarantees was

⁸ R Bertrams, op.cit., at 3.

⁹ QC Hapgood, *Paget's law of banking*, 12th ed., Butterworths, 2002, at 729.

¹⁰ R Bertrams, op.cit., at 8.

¹¹ G Penn, *The law and practice of international banking: Banking law*, vol. 2, London, Sweet & Maxwell, 1987, at 287.

an obstacle for American businesses that wanted to increase international trade, especially after the Second World War. There was a clear need of a viable instrument for guaranteeing performance under international contracts. In order to circumvent the prohibition and to meet the need of the market, American banks adapted the traditional letter of credit (which they were authorized to use) to a new use. The modern standby letter of credit came thereby into existence.¹²

The function of the standby letter of credit, i.e. the furnishing of security, and its mechanics, notably the rule of independence and the documentary nature of the conditions of payment are the same as those of the independent guarantee. They can be used for the same purposes and may contain the same conditions of payment. Accordingly, standby letter of credit and independent guarantee represent conceptually and legally the same device.¹³

Sources of law

Numerous efforts have been made at the international level to try to provide a framework for the harmonization of the law on bank guarantee. However, at a national level the development is very slow, as until now most countries do not have specific legislation on independent guarantees.

Uniform Rules for Contract Guarantees of the ICC 1978 (URCG)

In 1978, the International Chamber of Commerce issued the Uniform Rules for Contract Guarantees (URCG), ICC Publication No. 325 that proposes a set of internationally acceptable rules for certain types of contract guarantees. The purpose of these rules was to encourage more equitable practices in the area of bank guarantees by reducing the

¹²This instrument was initially referred to as “the guaranty letter of credit” but its title was quickly changed because it was felt that the word guaranty was inappropriate bearing in mind the prohibitions placed on U.S banks.

¹³R Bertrams, *op.cit.*, at 7.

opportunities for abuse. In order to do so, the rules made the payment claims under the guarantee dependent on the production of a court judgment or an arbitral award (Art. 9). Under the URCG the position of the principal was strongly enhanced obtaining a very good protection against abuse. However, the rules did not satisfy the expectations of the beneficiaries and of the banks, which act as guarantors in bank guarantees who insisted on a guarantee that was immediately enforceable.

Consequently, to try to respond to the expectations of the beneficiaries and banks while at the same time trying to limit the occurrence of abusive calls, the ICC developed a new set of rules known as URDG.

Uniform Rules for Demand Guarantees (URDG)

The limited recognition of the URCG prompted the ICC to issue a new set of rules. Hence, in April 1992 the ICC introduced the Uniform Rules for Demand Guarantees, ICC Publication No. 458. The URDG provides a framework for harmonizing international trading practices and establishes agreed upon rules for independent guarantees and counter-guarantees among trading partners. The rules specify uniform practices for securing payment and performance in worldwide commercial contracts.¹⁴ The goal of the URDG is to achieve a balance between the conflicting interests of the trading parties and curb abuse in the development of trade guarantees.

Consequently, in contrast to Art.9 of the URCG, Art 20 of the URDG does not require that the beneficiary furnish evidence on the occurrence of the risk covered by the guarantee. All the beneficiary has to do is to make a written demand of payment subject

¹⁴Seppala, The ICC Uniform Rules for demand Guarantees ("URDG) in practice: A decade of experience, see <http://www1.fidic.org/resources/contracts/Seppala-0601.asp> [Accessed 11 November 2007].

to the requirements contained in Art.20. These requirements as well as those contained in Art 21 are expected to provide some protection against an abuse of the guarantee.¹⁵

The fact that the World Bank and the UNCITRAL have adopted the URDG into their standards for financing international trade renders the rules an authoritative guide and promotes their worldwide acceptance.

International Standby Practices (ISP98)

The American Institute of International Banking Law and Practice adopted a set of standard rules for standby letters of credit known as ISP98. These rules were also published as ICC Publication No. 590. It is intended that ISP98 should be incorporated in standbys in the same way that the Uniform Customs and Practice for documentary Credits (UCP) is usually incorporated in commercial letters of credit. In the past, the UCP has been incorporated in standbys even though it was recognized that the UCP was not appropriate for standby credits. From this perspective, the users of standbys should welcome ISP98 as it is especially designed for this kind of security. However, from the general view that independent guarantees and standby letters of credit represent conceptually and legally the same device, it has been doubted whether the introduction of a separate set of rules for standby letter of credit was really useful or only an act of pride from the Americans. Indeed, the URDG and the ISP98 share together the same main features, which can be summarized as follows:¹⁶

- ❖ Contractual nature: The URDG and The ISP98 do not have force of law, but are of a contractual nature and thus require the explicit or implicit consent of the parties. Consequently, the parties are free to amend or exclude from their contract.
- ❖ Independence: The basic feature of the independent guarantee and standby letter of credit is the principle of independence (or principle of autonomy). This means that the obligations of the guarantor are completely separate from the underlying

¹⁵Under art. 21, the bank is obliged to immediately inform the principal of the written payment demand and must furnish this demand and any accompanying documents.

¹⁶R Bertrams, op.cit., at 31.

contract between the principal and the beneficiary. This notion is expressed in Art.2 (b) URDG and Rule 1.06 (a and c) ISP98.

- ❖ Documentary conditions: When placed before a demand guarantee or a standby letter of credit, banks act under the principle “banks deal with documents”. Accordingly, the duty of the bank is confined in the checking of the conformity of the prescribed documents. The documentary nature of the conditions of payment is stated in Art.2 (b) URDG and Rule1.06 (a/d) ISP98.
- ❖ Limited character: Although providing a comprehensive set of uniform rules, the URDG and the ISP98 do not provide an answer to each and every question that may arise. For example, the issue of fraud was not treated, as it is believed that it is not a matter of contract law.
- ❖ Transnational/national use: The URDG and ISP98 are primarily intended to be used in relation with cross border transactions and guarantees or standbys with parties established in different countries, however, there is no reason why they should not be used in relation with national transactions. After all, they have a contractual nature.

The U.N Convention on Independent Guarantees

International efforts have converged to produce some form of harmonized approach to deal with demand guarantees. Although the URDG and the ISP98 were already widely used and integrated into many contracts (contractual nature), these rules are nonetheless optional and do not represent law. Many countries felt the need to enact an internationally binding instrument for demand guarantees.¹⁷

On December 11, 1995, the General Assembly of the U.N., by a resolution taken in its plenary session, adopted the “United Nations Convention on Independent Guarantees and Standby letters of credit”. The decision to examine the feasibility and desirability of a greater universal uniformity in respect of demand guarantee and standby letters of credit was taken at the 21st session of the working group on International Contract

¹⁷ J Chuah, *Law of international trade*, 3rd ed., Sweet & Maxwell, London, 2005, p. 523

Practices in 1988. This convention has thus been the result of almost eight years of intense thinking.

The U.N Convention attempts to address the lack of uniformity in the regulation, terms, regime and character of demand guarantees and standby letters of credit by establishing a set of binding rules. Indeed, the lack of basic similarity between national laws concerning guarantees affected the growth of standbys in lieu of independent guarantees.¹⁸

Contrary to the URDG and the ISP98, the application of which depends solely on the parties' agreement (contractual nature), the Convention has the force of law once adopted by national Parliaments.

Case law and legal writing

Apart from the URGD, ISP98 and the UNCITRAL Convention, the most important sources of law are case law and legal writing. The Iranian revolution of 1979-1980 sparked off the first major bulk of litigation in a great number of countries, and this period can be characterized as the formative phase of the law on independent guarantees, as shaped by the courts.¹⁹ Since then, there has been a steady flow of case law.

Legal writing on the continent plays as well an important role in the development and understanding of independent guarantee. This is especially true for the initial phase when the law consisted of very few judicial decisions.

¹⁸ Illescas-Ortiz, 'International demand guarantees: The interaction of the Uncitral Convention and the URDG Rules of the ICC', 1998, *New developments in international commercial and consumer law*, Oxford, at 161.

¹⁹R Bertrams, *op.cit.*, at 36.

CHAPTER 1: OVERVIEW OF THE NOTION OF BANK GUARANTEE

1.1 Notion: Definition

The new U.N Convention, in art. 2(1) defines the type of undertaking regulated by it as ‘...an independent commitment , known in international practice as an independent guarantee or as a standby letter of credit, given by a bank or other institution or person (“guarantor/issuer”)to pay to the beneficiary a certain or determinable amount upon simple demand or upon demand accompanied by other documents, in conformity with the terms and any documentary conditions of the understanding, indicating, or from which it to be inferred, that payment is due because of a default in the performance of an obligation, or because of another contingency, or for money borrowed or advanced, or on account of any mature indebtedness undertaken by the principal/applicant or another person.’

This definition is slightly broader than the more detailed definition in art.2 (a) of the URDG, the scope of which is confined to guarantees in writing given for the account of a third party and providing for payment against a written demand and other specified documents.²⁰

Three features of this definition are noteworthy. Firstly, the U.N Convention is in line with international practice as it equally encompasses bank guarantee and standby letter of credit. Secondly, the definition is not confined only to first demand guarantee but it does include as well other types of guarantees. Finally, the payment demand must contain a declaration that the risk covered has materialized, against which the guarantee is to protect the beneficiary.²¹

²⁰R Goode, *Guide to the ICC Uniform Rules for Demand Guarantee*, ICC publication no 510, 1992, at 8.

²¹N Horn, op.cit., at 197.

A bank guarantee is thus an act of trust with full faith to facilitate the free flow of trade and commerce in international (or internal) trade or business. It is typically employed in construction contracts and contracts for the international sale of goods.

Legal nature

The drafters of the U.N Convention confined themselves just to giving a general description of what is a bank guarantee without expressing any opinion as to the legal nature of such instrument. Consequently, two schools of thought emerged regarding the nature of the bank's obligation under the bank guarantee.²²

One group of scholars argues that a bank guarantee is a unilateral obligation of a bank (or some other person), i.e., a unilateral transaction.²³ Such an understanding of a bank guarantee is based on Art.2 (a) of URDG, under which a demand guarantee means any guarantee given in writing for the payment of money on presentation in conformity with the terms of the undertaking of a written demand for payment.²⁴ According to this trend, the acceptance of the beneficiary is not required as the bank guarantee reflects only the will of a single person, the guarantor. Accordingly, the binding force of the bank's obligation and the terms and conditions are fixed as from the time of the issuance of the guarantee document.

The other trend of thought considers the bank's obligation to pay as one stemming from a consensual contract that comes into effect upon offer and acceptance.²⁵ Hence, for them a bank guarantee is a contract between the guarantor and the beneficiary. Accordingly, the issuance of the guarantee amounts to an offer, which must be accepted

²²The same issue has been raised in respect of documentary credit.

²³This view is shared as well by the Georgian law, see Paatakhotenashvili for further explanation.

²⁴Paatakhotenashvili, op.cit., at 333.

²⁵For instance German doctrine and case laws, French law as well as the Dutch have adopted the contractual view, see Paatakhotenashvili for further explanation.

by the beneficiary. It is common ground that the offer is generally accepted tacitly which acceptance is afterward evidenced by the call from the beneficiary.²⁶ Thus, by virtue of the issuance of the guarantee by the bank and the tacit acceptance of the beneficiary (the beneficiary's acceptance can be deemed to exist when he does not object), the bank and the beneficiary are contractually bound and they can no longer change or amend the terms of the guarantee.

This study opts for the consensual approach as it accords with the general principles of a majority of countries. However, it should be noted that it does not matter whether national laws adopt one or the other approach as in either view the guarantor cannot revoke its undertaking.

The object of the guarantee is the payment of a guarantee sum by a guarantor in favor of a beneficiary in accordance with a written demand of payment made by the beneficiary within a specified term. In accordance with the URDG, a bank, insurance company or other body or person may issue a bank guarantee.

1.2 Structure: Direct and indirect guarantee

1.2.1 Direct bank guarantee

A guarantee is a casuistic contract. It always derived from a relationship between the principal debtor and the creditor (beneficiary). This relationship is referred to as the underlying relationship or contract.

In order to safeguard the employer or buyer (referred therein as “creditor”) against non-performance or late or defective performance by the supplier or contractor (referred therein as “debtor”) international contracts usually contain a clause that demands the

²⁶R Bertrams, at 201.

debtor to provide a guarantee in favor of the creditor.²⁷ Pursuant to this clause, the debtor instructs his bank to issue a guarantee with the terms and conditions as specified by him. The relationship between the debtor and the bank embodies thus an internal mandate.²⁸ Of course, the bank is not obliged to carry out this instruction unless it has agreed to do so, and it will in any event require to be put in funds or to have other provision made to cover its prospective liability under the guarantee.²⁹ Under this relationship, the debtor becomes the principal, the bank the guarantor and the creditor the beneficiary. Should the bank be called to pay under the guarantee, the bank must pay provided that the demand and other documents (if any) conform to the terms and provisions of the guarantee and in the absence of fraud or other exculpatory ground. The bank will then claim reimbursement from the principal under its counter-indemnity contract.

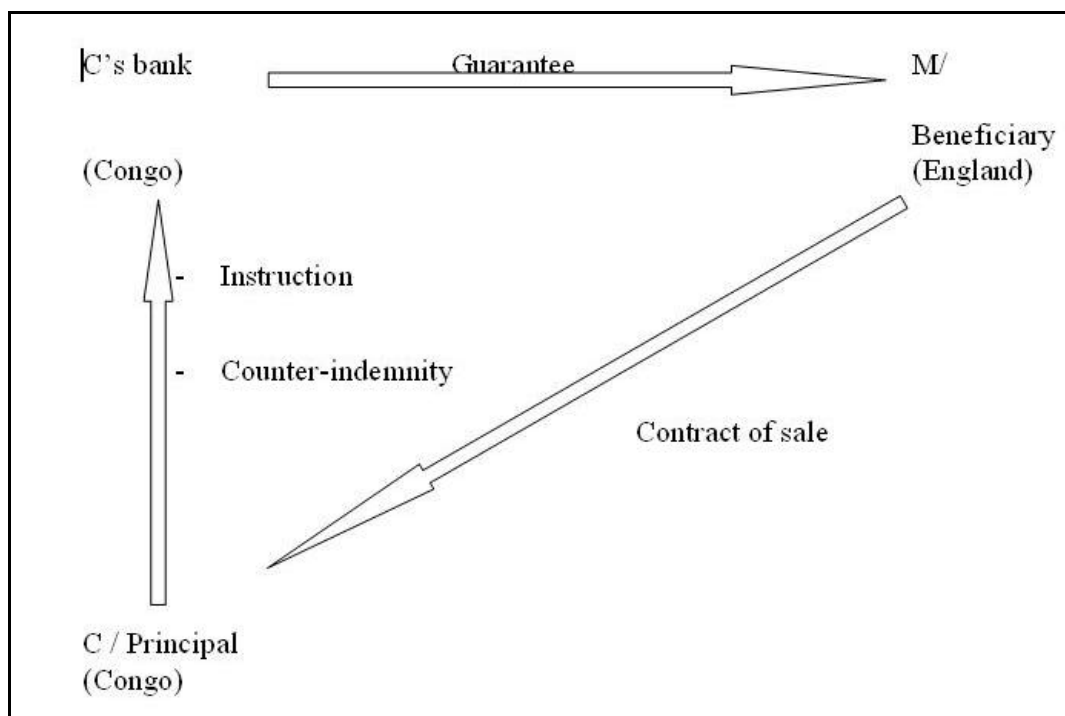
For example, C in the Congo has entered into a contract with M in England for the sale of cobalt to M, and it is the requirement of the contract that C provides a guarantee in favor of M to cover the risk of defective or late performance in the supply of cobalt. C instructs thus his bank in the Congo to issue the guarantee in favor of M. As soon as C's bank accepts to issue the guarantee, it becomes the guarantor and M becomes the beneficiary. In the event that M believes that C is in breach of his obligations under the contract, M will present a written demand in conformity with the terms and provisions of the guarantee to C's bank. C's bank has no option than to pay, after payment C's bank will ask for reimbursement to C. The reimbursement is called counter-indemnity.

This can be expressed diagrammatically as follows:

²⁷This occurs mainly when it is a first time contract and that the two parties have not yet built a relationship of trust.

²⁸The instructions contained in the mandate must be complete and precise stating the documents against which the bank is to make payment and the documents that will be unacceptable. This is important as a bank presented with an ambiguous mandate has several possible avenues of conduct. See art 7 URDG.

²⁹R Goode, *op.cit.*, at 10



A direct bank guarantee gives rise to three distinct contracts: The underlying contract between the debtor and the creditor; the counter-indemnity (or reimbursement contract) between the debtor and his bank; and finally the contract established between the debtor's bank and the creditor. However, it should be noted from the outset that these three contracts although related are completely independent.³⁰

The guarantor may decide to contact another bank in the creditor's country in order to check if the signatures on the guarantee appear to be genuine; such a bank is referred to as the advising bank. The advising bank will often be the branch or subsidiary of the instructing bank in the creditor's country. Otherwise, it is a local bank with which the instructing bank has regular business. However, the inclusion of the advising bank in the operation does not change the tripartite structure, as the advising bank does not incur any liability under the guarantee. Its role is confined to the notification and transmission of the guarantee as well as the transmission and communication from the beneficiary to the

³⁰ See for further explanation, Chapter 1. 1.3

bank; in other words, it plays the role of an intermediary in the operation.³¹ However, the advising bank must ascertain with reasonable care the authenticity of the documents on which it has to advise. In case of irregularities, the advising bank has the duty to ask the instructing bank to confirm their authenticity.³²

1.2.2 Indirect bank guarantee

The beneficiary may require the guarantee to be issued by a bank in his own country instead of relying on the principal's bank. This is common practice since it gives many advantages to the beneficiary on several counts. Firstly, the risk of currency exchange restriction is limited. Secondly, that bank can be the house bank of the beneficiary this means that it will be more inclined to pay under the guarantee and any problems will solve more smoothly than if it was with a foreign bank. Thirdly and finally, the national law of the beneficiary will govern the relationship between the beneficiary and the bank.³³

In such a situation, the principal asks his bank (here called the instructing bank) to arrange for the issue of the guarantee by a bank in the country of the beneficiary. Instructions are then given to the local bank, the issuing bank, by the instructing bank to issue a guarantee in favor of the beneficiary against a counter-guarantee from it. The instructing bank will be then entitled to an indemnity from its customer, the principal.

The adjective “indirect” refers to the structure of two links, notably mandate and counter-guarantee between the principal and the instructing bank, and instructions, mandate and counter-guarantee between the instructing bank and the issuing bank. This structure encompasses four contracts: The first contract is the underlying contract; the second contract reflects the relationship between the principal and the instructing bank (indemnity contract); the third contract is the relationship between the instructing bank

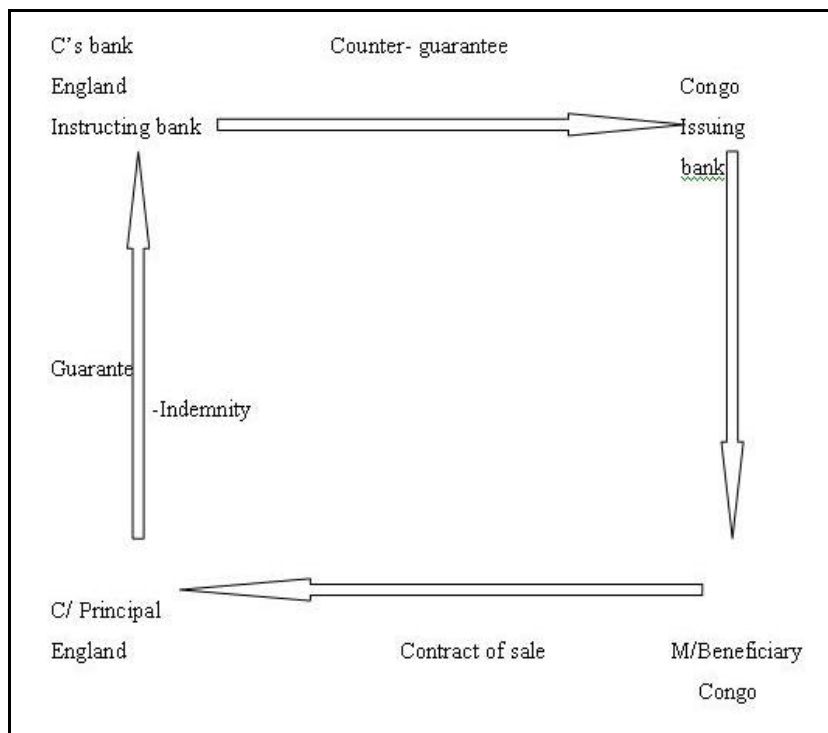
³¹ R Goode, *op.cit.*, at 11

³² Hans Van Houtte, *The law of international trade*, 2nd ed., London, Sweet&Maxwell,2002, at 267

³³ R Bertrams, *op. cit.*, at 78.

and the issuing bank (counter-guarantee contract) and the last contract is the most fragile in the entire structure and relates to the guarantee itself which is issued by the issuing bank to the beneficiary.³⁴

Expressed in diagrammatic form the structure is as followed;



1.3 Principle of independence

A demand guarantee generates the creation of various contracts (three when it is a direct bank guarantee and a total of four when it is an indirect bank guarantee) which are totally correlated to such an extent that the existence of one is only possible through the existence of the other. However, although the various contracts are functionally and commercially interdependent in some aspects, they are at the same time totally independent from each other.

³⁴ Idem, at 18

The principle of independence or autonomy is an essential feature of the structure and operation of bank guarantees. It is trite knowledge that the autonomy principle gives the bank guarantee its unique attraction as a method of finance in international commerce. The principle is embodied in art 2(b) URDG which provides that bank guarantees are by their nature separate transactions.³⁵ The meaning of this principle as well as the underlying explanation varies according to the selected point of reference.

1.3.1 Between the bank and the beneficiary

In this relationship, the principle of independence comprises two facets. Firstly, that relationship is not affected by the mandate relationship between the bank and the principal; secondly, the payment obligations of the bank and the beneficiary's right to payment are a very different transaction from the underlying relationship.³⁶ In respect of the first facet, independence means that the guarantor is not entitled to invoke a breach of the contract between him and the principal in order to refuse payment to the beneficiary. As a result, circumstances such as avoidance, repudiation of the mandate or insolvency of the principal as well as prior notice of refusal to repay the bank have no bearing in the obligation of the bank to pay the beneficiary. Indeed, the bank obligation to pay is an absolute undertaking and consequently it must meet its obligations whatever is the state of its relationship with the principal. In the same way, the bank cannot invoke any defenses available under the underlying contract to refuse to fulfill its obligation under the guarantee. This facet is one of the most important under the principle of independence. Indeed, although references to the underlying contract can be made in the guarantee the bank is not concerned on whether or not the beneficiary is in breach of his

³⁵Art. 2 URDG states:” *Guarantees by their nature are separate transactions from the contract(s) or tender conditions on which they may be based, and the Guarantors are in no way concerned with or bound by such contract(s), or tender conditions, despite the inclusion of a reference to them in the Guarantee. The duty of the Guarantor under a Guarantee is to pay the sum or sums therein stated on the presentation of a written demand for payment and other documents specified in the guarantee which appear on their face to be in accordance with the terms of the Guarantee.*”

³⁶ R Bertrams, op.cit., at 195.

contractual obligations with the principal.³⁷ Once the terms and conditions of the guarantee are met, the bank is obliged to pay unless fraud is proved.

1.3.2 Between account party and bank, indirect guarantee and counter-guarantee

The notion of independence between account party and bank as far as direct guarantees are concerned means that the obligations and right to reimbursement are not affected by the underlying relationship. The bank cannot be affected by the disputes that may divide the principal and the beneficiary.

When a counter-guarantee is issued - that is in an indirect guarantee -, the counter-guarantee possesses the same independence from the guarantee as the latter from the underlying contract. The counter-guarantee is payable under its own terms. Consequently, once the guarantor meets all the requirements under the counter-guarantee, the guarantor is entitled to payment whether or not the guarantor has paid the beneficiary or has received a demand for payment or is legally liable to pay a demand received.³⁸

1.3.3 Between parties to the underlying contract

Here the notion of independence finds its application in the principle “pay first, argue later”, i.e. their agreement that payment by way of compensation is to be effected once the agreed conditions of the guarantee have been complied with, for instance a simple demand for payment with or without a statement of default or presentation of third party

³⁷This is one of the differences between a bank guarantee and a surety. Indeed, under a surety the guarantor is able to invoke the defenses in the underlying contract since its obligation to pay is conditional on the default of the principal in the underlying contract. That is why a surety is said to be a secondary obligation on the part of the guarantor.

³⁸R Goode, *op.cit.*, at 10.

documents evidencing default, in derogation of the ordinary determination of default, which would have to be pursued but for this special agreement.³⁹

The principle of independence is of particular interest especially for banks. Indeed, in accordance to the principle the duty of the bank is confined to verifying whether the terms of the guarantee have been complied with. The bank is thus expected merely to compare the documents presented to it by the beneficiary with the documents prescribed in the guarantee. However, this principle should not be too rigid and inflexible to the extent of undermining other important policy concerns of the law. Thus, it is now widely accepted that the autonomy principle may be breached in certain exceptional circumstances in order to give effect to other important policy considerations, such as the need to combat fraud.⁴⁰ While the fraud exception in the autonomy principle is well established, it is unclear to what extent illegality can provide the basis for a defense to a claim under a bank guarantee.⁴¹

1.4 Mechanism of payment

The payment mechanism forms the heart of the guarantee; it determines the actual benefits of the beneficiary and the risk exposure for the principal. There are three mechanisms of payment: payment on first demand, which does not require any proof of default from the principal; payment upon submission of an arbitral or court decision, which hardly differs from a suretyship, and finally; payment upon submission of third party document, which occupies an intermediary position between the two first. Although these mechanisms differ in respect of the degree of proof of default by the

³⁹R Bertrams, *op.cit.*, at 196.

⁴⁰N Enonchong, 'The autonomy principle in letter of credit: an illegality exception?', [2006] *LMCLQ* 289-446.

⁴¹Indeed, whether the English law recognizes an illegality exception has not yet received a similar authoritative response despite the recent decisions of the High Court in *Mahonia Ltd v. JP Morgan Chase Bank*, [2003] 2 Lloyd's Rep. 911

principal, they all have a documentary nature. Consequently, the duty of the bank is confined to pay when the documents presented to it are correct. Indeed, the general rule is that banks in bank guarantee are obliged to pay upon the presentation of the conforming documents by the beneficiary. The documents presented under the bank guarantee must strictly comply with the terms and conditions contained in the bank guarantee. If the documents do not comply with the terms of the guarantee and the bank nevertheless makes a payment, it will not be entitled to reimbursement from the principal as it will have exceeded its mandate. However, if the documents do comply with the guarantee then payment must be made. This principle is generally known as “the doctrine of strict compliance”. The doctrine of strict compliance is embodied in Art.9 of the URDG.⁴² The wording of Art.9 of the URDG is very similar to that of the UCP 500 Art.15. It seems thus, that the apparent intention is that the standard of compliance in relation should be the same as for a documentary letter of credit. Accordingly, all a bank is to do is to determine, based on the documents alone, whether they appear on their face to comply with the terms and conditions of the guarantee without consideration whatsoever to the underlying contract.⁴³

1.4.1 Payment on first demand

This form of payment is the most used in international trade as it offers to the beneficiary a considerable advantage. It is known by many as the “suicide” form of payment. Under this form, the obligation of the bank to make payment is not subject to any forms of proof or conditions. The advantage of such a guarantee is obvious, since the beneficiary can call it without any evidence or corroboration concerning the principal’s default or any entitlement of payment under the guarantee. All the beneficiary is to do is to adduce a written demand of payment.

⁴²P Sellman, *Law of international trade*, 4th ed., Old Bailey Press, 2003, at 148.

⁴³The doctrine of strict compliance will be examined in more details in the chapter 3.

There are two variants of first demand guarantee: The one that does require only a simple written demand without any others additional documents from the beneficiary characterized as the “simple demand guarantee” and the one that requires a statement of default by the principal. The URDG deals with the latter kind of first demand guarantee. The idea is to establish a balance between the liquidity of payment that renders the guarantee attractive and the need to protect the principal from unfair calling by the beneficiary. Consequently, Art.20 (a) URDG states that the beneficiary’s written demand must be accompanied by a unilateral declaration of the principal’s default specifying the nature of the default. In *I.E Contractors Ltd. v. Lloyds Bank Plc. And Rafidain Bank* , Staughton LJ suggested that a construction which requires the demand to assert a breach of contract is a construction which ‘one would wish to adopt, since it requires the beneficiary to state in plain terms that which he must, if honest, be prepared to assert – and may place him in peril of a charge of obtaining money by deception if it is untrue to his knowledge.’⁴⁴

Because of the lack of requirement of other documents, the first demand guarantee is also referred to as the “unconditional” demand guarantee as opposed to the kind of guarantees which require the submission of documents others than a unilateral statement by the beneficiary, known in international trade as “conditional” demand guarantees. These kinds of guarantees encompass the guarantee paid upon submission of third party documents and the guarantee paid upon submission of an arbitral or court decision.

1.4.2 Payment upon submission of third party documents

The principal has no protection against unilateral, unfair, and /or capricious demand by the beneficiary under a first demand guarantee, especially under a simple demand guarantee. This has led to financial catastrophe for many contractors in recent years, and in order to mitigate the harsher implications of this form of payment, it is becoming

⁴⁴[1990] 2 Lloyd’s rep. 496 at 500.

increasingly common to see clauses giving a degree of protection against an unscrupulous beneficiary.⁴⁵ One of the ways of limiting the risks of an unfair call is the requirement of submission of third party documents before the bank makes any payment under the guarantee.

By definition, guarantees payable upon submission of third party documents are independent guarantees and they can be made subject to the URDG or ISP98. Accordingly, the beneficiary is entitled to payment forthwith if he submits the documents required by the guarantee. There is no need for him to adduce any other evidence of the principal's default. This is in line with the principle of autonomy governing all independent guarantees.

There is a variety of documents suitable as conditions of payment demanding of the type of guarantee. For instance, a guarantee may require the presentation of a statement from a notary public confirming that the beneficiary has accepted the principal's tender and that the latter has failed to perform (this in case of a tender guarantee). As for a performance guarantee, the guarantee could call for certificates from an independent expert or surveyor, which indicates non-performance of the contract by the principal. It is noteworthy to remark that the presentation of the required documents does not automatically imply that the principal is liable under the law. For instance, in the case of occurrence of case of force majeure, the surveyor will still certify the non performance of the principal even though force majeure is a legal exception that frees the principal for performance under the contract.

1.4.3 Payment upon submission of an arbitral or court decision

A third type of payment mechanism involves the submission by the beneficiary of an arbitral or court decision, which affirms the principal's liability to the beneficiary as a condition of payment.⁴⁶ This kind of payment is particularly frequent in the case of

⁴⁵G Penn, *op. cit.*, at 270.

⁴⁶R Bertrams, *op.cit.*, at 58.

judicial guarantees, furnished in order to have a conservatory attachment lifted. Otherwise, a guarantee upon submission of an award or judgment is believed to be rare in international trade.

This type of payment mechanism is often compared to a suretyship as all the defenses available under the underlying contract are already considered before the court or the arbitral tribunal. However, they are conceptually different. In the case of this type of guarantee, the bank's duty is confined to the examination of the arbitral or court decision in order to determine if they comply on their face to the requirement of the guarantee while, in a case of a suretyship the bank becomes involved in the underlying contract in raising personally all possible defenses that the principal could have raised.

1.5 Types of guarantee

The variety of risks which attend the conclusion and execution of contracts or which result from advance and interim payments has engendered various types of guarantee. All guarantees serve basically the same overall purpose namely the protection against non-performance, however it has been deemed appropriate to have separate guarantees for particular phases of performance rather than to have a single guarantee covering all the stages of performance. This has the advantage to limit the liability of the principal to the amount corresponding to a single phase of performance. Among the range of demand guarantee are: the tender guarantee, performance guarantee, advance payment guarantee, retention guarantee, maintenance guarantee...For the purpose of this study, only these types of guarantee will be reviewed although there are others forms of guarantee such as the judicial guarantees and the customs guarantee

1.5.1 Tender guarantee

Construction contracts and major contracts for the supply of goods are often awarded through tender procedures. The buyer or employer favors this form of trading because it allows them to ascertain the best price for the goods and the best available service for

the order. Furthermore, tender guarantees are usually used when the contract is of high value or when the project being tendered is time critical.

Where tenders are invited it is often a condition of consideration of the tender that the tenderer provides a tender guarantee as assurance for the employer or buyer of his intention to sign the contract and comply with the terms of such contract in the event of his tender being accepted.⁴⁷ Indeed, it is not unknown for a supplier to submit a tender for a contract and then refuse to proceed with the contract when the contract is awarded to him. The purpose of such guarantee is to compensate the beneficiary of the guarantee for the additional costs he may incur in re-awarding the contract to another party.⁴⁸ Consequently, if after being awarded the contract the principal fails to proceed as planned i.e. if he fails for instance to sign the contract, or withdraws his tender before its expiry, the beneficiary is entitled to make a written demand under the terms of the guarantee.

Once the tender has been accepted, and assuming that the customer is willing to proceed, it will normally be necessary to replace the tender guarantee with a suitable performance guarantee. Some tender guarantees, however, are drafted in such a way that they automatically become performance guarantee once the tender is accepted.⁴⁹

1.5.2 Performance guarantee

Performance guarantees are the instruments most frequently used in international trade. They can be characterized as the counterpart of a documentary credit. Indeed, while a documentary credit assures payment in anticipation of proper performance by the seller, a performance guarantee assures payment in the event that the seller has not fulfilled his

⁴⁷ G Penn, op.cit., at 262.

⁴⁸These costs may be considerable where the tender process is to start afresh.

⁴⁹G Penn, op.cit. , at 263.

obligation under the contract.⁵⁰ For instance, if the buyer is uncertain that the seller will supply the goods sold, he will require a performance guarantee in order to safeguard his position. Accordingly, if the seller does not perform his obligation under the contract of sale the buyer will simply have to make a demand. The performance guarantee is the guarantee of the central performance of the contract from commencement to completion. Indeed, unless otherwise expressly stated in the contract, the ambit of the performance guarantee extends not only to the delivery of the goods but includes the installation, contractual warranty obligations, and all other obligations that form part of the principal contract.

Performance guarantees are usually requested within a few weeks of the contract being awarded, however in some cases they can be a prerequisite for the formation of the contract. In such an event, the guarantor should give its commitment in order for the contract to be effective.

1.5.3 Repayment or advance-payment guarantee

Advance payment guarantees are issued in circumstances where the seller negotiates for an advance payment. The repayment guarantee seeks to ensure the buyer that the money advanced will be returned in case of non-performance of the contract by the seller. They are particularly common in construction contracts, where the constructor needs a certain amount of money in order to enable him to start with the first phase of construction.⁵¹

Generally, repayment guarantees contain a reduction clause by virtue of which a mechanism of reduction of the maximum amount is provided upon evidence of progressive performance. Consequently, the maximum amount is reduced to zero once the performance has been completely completed. It should be noted that the ambit of the repayment guarantee is broader than that of the performance guarantee. Indeed, while a repayment guarantee should be considered as a “loan” being reimbursable even in the

⁵⁰R Bertrams, *op. cit.*, at 39.

⁵¹G Penn, *op.cit.*, at 265.

event of force majeure or voidance of the contract, a performance guarantee is only provided to secure any losses that the buyer may incur because of a breach of contract.

1.5.4 Maintenance or warranty guarantee

Maintenance guarantees are issued to ensure the employer or buyer of compensation in the event any defects or malfunctions become manifest after delivery of the goods or after provisional or substantial completion of the plant, during the maintenance or defects liability period.⁵² A maintenance guarantee serves the same purpose as a performance guarantee even if the maximum amount of maintenance guarantee tends to be considerably lower than a performance guarantee.

A maintenance guarantee can also be furnished in order to persuade the employer to release the last installment of the contract price, which he would otherwise have withheld as security for repairs or supplemental works by the contractor during the maintenance period.⁵³

1.5.5 Retention guarantee

Construction contracts usually provide for stage payments against architects' or engineers' certificates and for a specified percentage of the amount certified in each certificate to be retained by the employer for a specified period of time as a safeguard against defects.⁵⁴ The interim payments will enable the contractor to improve his cash flow position. The purpose of the retention guarantee is similar to repayment guarantee in that it ensures to the employer a refund of the interim payments made and like

⁵²The liability period is the period during which the contractor or seller remains responsible for the adequate functioning of the work or of the quality of the goods. In construction contracts, this period is usually of ten years after completion of the contract.

⁵³R Bertrams, *op.cit.*, at 41.

⁵⁴R Goode., *op.cit.*, at 14.

performance guarantee, it indemnifies the employer if the contractor fails to meet his contractual obligations.

The employer may be willing to release the retained money against a retention guarantee securing repayment of the released retention moneys if defects later occur or if the contractor fails to perform under the contract. The amount of the retention guarantee usually varies between five and ten percent of the stage payments.

CHAPTER 2: THE CONCEPT OF FRAUD

Introduction

The bank guarantee is a device, which provides certainty of payment for the beneficiary. However, the increased certainty for the beneficiary amounts to an increased risk of loss for the principal. Consequently, the balance of risk is considerably tipped in favor of the beneficiary, especially in the case of first demand guarantee. However, while the principle of independence achieves the desired commercial result in the majority of cases and the principal is willing to be exposed to the risk of loss for the eventual gains effected by a successful deal, the principle may give rise ---if applied too rigidly--- to inequitable results in one recurring situation: when the transaction is tainted by fraud.⁵⁵ Indeed, fraud does attack the basic principles of every law of equity and justice. Therefore, protecting the bank's obligation of payment in the fields of demand guarantee without exception, when documents are in accordance with their terms and conditions, would lead to unpermissible protection of fraud. The courts have thus attempted to establish a balance between the commercial utility of bank guarantees and the desire to prevent unlawful result that may result from fraudulent actions on the part of the beneficiary. The balance has been achieved through the fraud exception.

The fraud exception allows the bank or the court to disrupt the functioning of the bank guarantee when fraud is involved. The fraud exception relies on the maxim "*fraus omnia corrumpit*" (fraud derails anything) which entitles and obliges the bank not to make payment where documents are presented by a fraudulent beneficiary. This exception thus goes to the heart of the demand guarantee obligation as it pierces the veil of the principle of autonomy. Although such exception is necessary to limit the activities of fraudsters, its scope should be carefully circumscribed so as not to deny commercial utility to an instrument that exists to serve as an assurance of performance under the

⁵⁵J Browne, 'The fraud exception to standby letters of credit in Australia: Does it embrace statutory unconscionability?' (1996), vol.11, *Bond Law Review*, at 101.

underlying contract or repayment of down payments made.⁵⁶ Indeed, it is only natural for the principal, when the risk of a call has materialized, to claim that the demand for payment is fraudulent since, in practice the only available defense to escape payment under an independent guarantee is the one of fraud.⁵⁷

Authors agree that the term "fraud" and "abuse" can be use interchangeably. Indeed, it has been observed that a demand for a payment to which the beneficiary is not entitled would constitute an abuse of right and at the same time, it would represent fraudulent conduct towards the principal. Consequently, in this study the notion of fraud will embody abuse of right. Furthermore, even though the majority of cases analyzed in this study are in relation to commercial letters of credit, the autonomy principle and the application of the fraud exception apply equally to demand guarantees. (Indeed, In *Harbottle v. National Westminster Bank Ltd*,⁵⁸ Justice Kerr drew an analogy with cases dealing with confirmed letter of credit, suggesting that such cases applied equally to first demand performance guarantee). However, compared with commercial letters of credit, fraud in the form of forged or fraudulent documents is of minor significance.

2.1. Comparative overview

2.1.1 United Kingdom

In the United Kingdom, fraud is extremely difficult to establish pursuant to the standard applied on the facts of the cases. Indeed, English courts have traditionally adopted a relatively rigid and narrow approach towards the application of the exception of fraud requiring a high standard of proof. Furthermore, the evidence has to be immediately

⁵⁶G Xiang and RP Buckley, 'A comparative analysis of the standard of fraud required under the fraud rule in letter of credit law', (2003), vol. 13: 293, *Duke Journal of comparative and International Law*, at 293.

⁵⁷ R Bertrams, op.cit., at 257.

⁵⁸ [1977] 2 All E.R. 862

available without the need for in-depth investigation into the underlying contract.⁵⁹

The position in the United Kingdom illustrates the reluctance of the courts to interfere with the bank's absolute undertaking and to allow an exception of the principle of independence if it would affect the position of the bank. Indeed, English courts consider that if they were to find fraud too readily international commercial practice would be adversely affected. This position finds its source in the seminal case of *Harbottle v. Nat. Westminster Bank* Where Justice Kerr stated:

'It is only in exceptional cases that the courts will interfere with the machinery of irrevocable obligations assumed by banks. They are the life-blood of international commerce...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...'⁶⁰

In the more recent case of *United Trading Corporation SA v. Allied Arab Bank Ltd.*,⁶¹ this position was confirmed as the Court of Appeal held that interlocutory injunctions restraining a bank from honoring its obligations would only be granted where there are evidences that the beneficiary calls on the bond fraudulently, and the bank has actual knowledge of the fraud. It appears thus that according to English law, fraud must be proved not only on the part of the beneficiary but also knowledge of such fraud on the part of the bank. Accordingly, in the case of an indirect guarantee knowledge of fraud must be shown on the part of the issuing bank and the instructing bank. Moreover, in the United Kingdom the fraud exception applies to both fraud in the documents and fraud in the underlying contract. Indeed, in *Edward Owen Engineering Ltd. v. Barclays Bank International Ltd* Lord Denning after quoting from *Sztejn* stated: '...the bank ought not to pay under the credit if it knows that the documents are forged or that the request of

⁵⁹ R Bertrams, op. cit., at 265

⁶⁰[1977] 2 ALL E.R. 862, at 878.

⁶¹[1985] 2 Lloyd's Rep. 554.

payment is made fraudulently in circumstances when there is no right of payment'.⁶²

Another hurdle in relation to fraud in English law is the standard applied by courts in order to recognize fraud and consequently grant an injunction for stop payment under the guarantee. Ackner L.J in *United Trading Corp. v. Allied Arab Bank* particularized the standard of proof of fraud as follows :

'We would expect the court to require strong corroborative evidence of the allegation, usually in the form of contemporary documents, particularly those emanating from the buyers...If the court considers that on the material before it the only realistic inference to be drawn is that of fraud, then the seller would have made out a sufficient case of fraud'.⁶³

In others words, the proof must be clear and the fraud must be established to an extent where there may not be another explanation which excludes fraud.

In summary, therefore, the fraud exception with respect to demand guarantees in English law requires common law fraud, and the fraud must be clearly particularized and established on the part of the beneficiary and the bank. There is thus no doubt that in this regard English law is more stringent than that of other jurisdictions as regards the test for fraud and evidence of fraud.

2.1.2 United States of America⁶⁴

It is extremely difficult to define the perception of the notion of fraud as emerging from the abundant American cases law. However, article 5 of the Uniform Commercial Code

⁶²[1978] QB 159 (CA).

⁶³[1985] 2 Lloyd's Rep.554.

⁶⁴ All the cases concerning the position of the United States of America are extracted from G Xiang and R P Buckley, op.cit.

(UCC) contains state-of-the-art provisions with respect to the fraud rule.⁶⁵ In order to facilitate the analysis, the U.S. position will be examined in two parts: the prior U.C.C. article 5 and the revised U.C.C. article 5; indeed recently, the UCC has undergone a major revision.

- Prior U.C.C. article 5 position

Although dealing with the issue of fraud in a demand guarantee, the provisions of the prior art.5, section 114(2) did not give any hint as to what type of fraud is required to allow a bank to refuse payment under a guarantee. Consequently, different standards of fraud were proposed by courts when placed in front of allegations of fraud.

a) Constructive fraud: The notion of constructive fraud was first suggested in *Dynamics Corp. of America v. Citizens & Southern Nat'l Bank* where the United States District Court for the Northern District of Georgia stated: '...Fraud, indeed, in the sense of a court of equity properly includes all acts, omissions and concealments which involve a breach of legal or equitable duty, trust, or confidence, justly reposed, and are injurious to another, or by which an undue and unconscientious advantage is taken of another.'⁶⁶

In accordance with this judgment, any conduct of the beneficiary that breaks even an equitable duty may lead to the application of the fraud rule.⁶⁷ Per consequent, if it can be proved that the beneficiary's demand has no conceivable basis, in rapport of the underlying contract, and he still makes a demand for payment a fraudulent intent will be imputed to him.⁶⁸ This standard is undoubtedly very low, as it does not consider the essence of a demand guarantee, which is the autonomy principle. Such standard constitutes a threat to the popularity of demand guarantees as it may lead to the abuse of

⁶⁵The UCC embodies the major corpus of American commercial law.

⁶⁶356 F. supp.991 (N.D. Ga.1973).

⁶⁷G Xiang. and R P Buckley, op.cit., at 308.

⁶⁸R Bertrams, op.cit., at 269.

the fraud rule by the principal and ultimately vitiate the reliability and commercial utility of demand guarantees. Therefore, such standard should be avoided.

b) Intentional fraud: The idea that intentional fraud can invoke the fraud rule was formulated by the New York Supreme Court in the case of *NMC Enterprises v. Columbia Broadcasting System, Inc.*, which stated that where there are no innocent third parties involved in a documentary credit and where the documents or the underlying transaction are tainted with intentional fraud the bank has the duty not to honor such draft even though the documents conform on their face.⁶⁹ This position was confirmed in *American Bell International v. Islamic Republic of Iran*.⁷⁰ From the reasoning of these two cases, it appears that the standard of intentional fraud requires a misrepresentation made knowingly with the intention of inducing another to rely on. This is a very stringent approach of the notion of fraud and thus put very high the standard of fraud under the demand guarantee. However, the hurdle of such standard is to prove the fraudster's state of mind to defraud. This is particularly true in the case of first demand guarantees where apart from the written demand there are no other documents required.

c) Flexible standard: According to the flexible standard, the degree of fraud necessary to justify the interference of the court is somewhere between a breach of warranty and an outright fraudulent practice. Therefore, if there is only a breach of warranty, the fraud rule would not be invoked; however, if outright fraudulent practice is clearly established, the fraud rule will certainly apply. This means that the relevant standard of fraud requires of the beneficiary's misconducts something more serious than mere breach of warranty.⁷¹

The seminal case in respect of the flexible standard of fraud is *United Bank Ltd. v. Cambridge Sporting Goods Corp.* In this case, the New York Court of Appeal observed:

⁶⁹ 14 U. C. C. REP. SERV. 1427 (N.Y. Sup. Ct. 1974) at 1429.

⁷⁰ 474 F. Supp. 420 (S. D. N. Y. 1979).

⁷¹ G Xiang and R P Buckley, op.cit., at 307.

‘It should be noted that the drafters of section 5-114, in their attempt to codify the *Sztejn* Case and in utilizing the term "fraud in the transaction", have eschewed a dogmatic approach and adopted a flexible standard to be applied as the circumstances of a particular situation mandate. It can be difficult to draw a precise line between cases involving breach of warranty (or a difference of opinion as to the quality of the goods) and outright fraudulent practice on the part of the seller.’⁷²

The standard of flexible fraud seems to be a laudable standard since it exactly serves the purpose of the fraud rule. Indeed, it intends to stop occurrences of fraud in instruments such as demand guarantee without becoming involved in disputes arising out of the underlying contract. Nevertheless, one should be cautious in the interpretation of the term "flexible"; indeed, this standard might be misapplied in practice in unanticipated "flexible" ways.

d) Egregious fraud: The elements of egregious fraud are not completely clear, however, the term has been invoked to highlight a very serious misconduct on the part of the beneficiary. Different meanings of "egregious" were proposed, one suggestion is that the term means "a flagrant violation of the beneficiary's obligation under the letter of credit [demand guarantee]".⁷³ Another proposition is that egregious means "outrageous conduct of the beneficiary which shocks the conscience of the court."⁷⁴ In the oft-mentioned case of *Intraworld Industries v. Girard Trust Bank.*, the reasoning of the court was as follows:

‘ In the light of the basic rule of the independence... the circumstances which will justify an injunction against honor must be narrowly limited to situations of fraud in which the wrongdoing of the beneficiary has so vitiated the entire transaction that the legitimate

⁷²392 N.Y. S. 2d 265, 271 (N.Y. 1976) at 271.

⁷³G Xiang and R P Buckley, op. cit, at 299.

⁷⁴R Bertrams, op. cit, at 269.

purposes of the independence of the issuer's obligation would no longer be served.⁷⁵

It appears thus that under the egregious standard of fraud, the wrongdoing of the beneficiary has to have the effect of vitiating the entire transaction in such an extent that the legitimate purposes of the independence of the issuer's would no longer be served.⁷⁶

- Revised U.C.C article 5 position

Article 5 of the U.C.C has been revised in August 1995 and was published by the American Law Institute and National Conference of Commissioners on Uniform State Laws. The revision was undertaken in an effort to respond to changes in the commercial practices involving letter of credit and a significant increase in litigation. The revised art.5 adopted "material fraud" as the standard of fraud under the fraud rule. According to the Official Comment, material fraud in relation to standby letter of credit occurs only when the beneficiary has *no colorable right to expect honor* and where there is *no basis in fact to support such a right to honor*. However, the article does not require a proof of the beneficiary's intention to defraud. It appears thus that the article put more emphasis on the severity of the effect of the fraud on the transaction rather than on the beneficiary's state of mind.⁷⁷

Prior to the revision of the UCC, there was uncertainty as to whether the concept of fraud extended only to the transaction between the bank and the beneficiary or whether it applied as well to the underlying contract between the principal and the beneficiary. Indeed, it has been argued that the extension of the concept to the underlying contract

⁷⁵336 A.2d 316 (Pa. 1975) at 324-325. Although it is the first case to have introduced the standard of egregious fraud, it is *New York Life Insurance v. Hartford National Bank and Trust*, 378 A. 2d 562 (Conn. 1977) that actually mentioned the term "egregious".

⁷⁶Some examples of other cases decided on the basis of egregious fraud: *First Arlington Nat. Bank v. Stathis* [1980] 90 Ill. App. 3d 802, 46 Ill Dec. 175,413 NE 2d, 1288, 32 UCCRS 260; *Stringer Construction Co. v. American Ins. Co.* [1981] 102 Ill. App. 3d 919, 58 Ill Dec. 59, 430, NE2d. 1, 32 UCCRS 1167, 25 ALR 4th. 230.

⁷⁷G Xiang and R P Buckley, op.cit., at 317.

would undermine the principle of independence in demand guarantees. In order to settle the discussion, the new provisions clearly recognize that fraud may relate to the underlying contract. This approach is laudable especially in respect of first demand guarantee where there are no documents involved. Indeed, a narrow approach would have rendered the fraud rule a myth as it would have been virtually impossible to prove fraud.

2.1.3 Australia⁷⁸

In Australia, two kinds of standard of fraud have been suggested: intentional fraud and gross equitable fraud.

a) Intentional fraud: The standard of intentional fraud embodies the idea of deceit on the part of the beneficiary in order to obtain payment. It is formulated and elaborated in the same manner as in the US and therefore presents the same difficulties as to the proof of the beneficiary's state of mind. This standard was set forth in the case of *Contronic Distributors Pty. Ltd. v. Bank of New South Wales*, Where Justice Helsham said: 'It seems to me that the case can be decided on a simple basis of fraud.... [It] is sufficient to enable... Balfour..., in any event to get relief in these proceedings, to establish an intention to obtain money by deceit on the part of GEC at the time that the letter of credit is to be presented by it for payment.'⁷⁹

b) Gross equitable fraud: The idea that gross equitable fraud may invoke the fraud rule was suggested in *Hortico Pty. Ltd. v. Energy Equip. Co Pty. Ltd* where Judge Young of the Supreme Court of New South Wales said: ' With commercial transactions such as the present [bank guarantee], the courts have consistently taken a "hands off" approach, and it does not seem to me that anything short of actual fraud would warrant this court in intervening, though it may be in some

⁷⁸ The cases concerning the Australian position have been found in G Xiang and RP Buckley, op.cit.

⁷⁹[1984] 3 N. S. W. L. R. 110 (N. S. W. S. Ct.) at 114.

cases , the unconscionable conduct may be so gross as to lead to exercise of the discretionary power'.⁸⁰

Thus, the concept of "gross equitable fraud" equals to "gross unconscionable conduct". The suggestion that gross equitable fraud may invoke the fraud rule was rejected by Judge Batt of the Supreme Court of Victoria in *Olex Focas Pty. Ltd. v. Skodaexport Co.*⁸¹ The case involved a contract between Olex Focas and Skodaexport for the supply and installation of telecommunications, telesupervisory and instrumentation systems work on a pipeline. In order to secure his position under the contract Skodaexport required Olex Focas to provide two independent guarantees, one termed mobilization guarantee and the other performance guarantees. All guarantees were payable at sight without protest or demur of proof. A dispute arose between the parties about whether the work done by Olex Focas fulfilled the contractual obligations of the latter. Skodaexport threatened to call upon the demand guarantee unless Olex would accept its terms for the settlement of the disputes. Olex sought an interlocutory injunction alleging that the threat made by Skodaexport was either fraudulent or a breach of the unconscionable conduct provisions of the *Trade Practices Act*. When considering the second ground for the injunction, i.e. whether gross equitable fraud might invoke the fraud rule, justice Batt said :

‘...I would not with respect, having regard to all the other cases I have cited, treat gross unconscionability falling short of actual fraud as a ground for injunction’.⁸²

⁸⁰[1985] 1 N. S. W. L. R 545 (N. S. W. S. Ct) at 554.

⁸¹[1996] 134 F. L. R 331 (V. S.Ct).

⁸²Justice Batt referred to the Oxford English Dictionary to define the word unconscionable as follows: "Showing no regard for conscience; not in accordance with what is right or reasonable". A better definition of unconscionability was suggested in *Mc Connell v. SembCorp* [2002] BLR 450, at 75 in which the Singapore court held: "The concept of unconscionability involves ...unfairness as distinct from dishonesty or fraud, or conduct of a kind so reprehensive or lacking in good faith that a court of conscience would either restrain the party or refuse to assist the party. " It appears thus that the position in Singapore is different from the one in Australia. Indeed, in Singapore unconscionability constitutes a separate ground for injunction while in Australia the concept must be embodied in a case of fraud to justify a relief of injunction.

Thus in Australia, although two kinds of fraud were suggested, it is only the notion of intentional fraud that has been successfully applied until now.

2.1.4 Uncitral Convention

The Uncitral convention is a paramount contribution to the law of demand guarantees and standby letters of credit. Indeed, the Uncitral convention for the first time contains a clear codification of the various situations where fraud is present, and requires, as in all jurisdictions, a manifest, and clear evidence as to this situation. Art.19 of the convention gives an appropriate significance to the classical and always controversial exception of fraud. Indeed, the article specifically defines the circumstances in which payment can be withheld and thus establishes a high degree of certainty in respect of the fraud exception, even though it has avoided using the terms fraud and abuse of right.⁸³ According to art.19, the three substantive grounds to invoke the fraud rule are when:

- (a) Any document is not genuine or has been falsified;
- (b) No payment is due on the basis asserted in the demand and the supporting documents; or
- (c) Judging by the type and purpose of the undertaking, the demand has no conceivable basis.

Article 19(2) goes on to specifically cite in which kind of situations the demand will be considered as having no conceivable basis. However, some of these situations are controversial. Firstly, in respect of the first situation the article says: 'where the contingency or risk against which the undertaking was designed to secure the beneficiary has undoubtedly not materialized.'The convention does not explain what is the standard to be applied in determining whether a contingency has occurred. Accordingly, it is unclear to determine the occurrence of such contingency or risk. A second situation that may give rise to controversy is contained in art. 19(2)(c) which states that where the underlying obligation has undoubtedly been fulfilled to the satisfaction of the beneficiary then the demand must be said to lack a conceivable basis.

⁸³Illescas-Ortiz , op.cit, at 168.

What is problematic here is that the reference to “undoubtedly” is unclear. Although there is no doubt that it is an objective test that must be applied, it remains open to different banks to adopt different standards of proof. Consequently, different jurisdictions have applied different standards.⁸⁴

From the above analysis of art. 19, it appears that the convention gives more attention to the nature of the beneficiary's misconduct rather than of its state of mind, indeed the convention does not require any proof as to the beneficiary's intention to defraud. Furthermore, the convention clearly shows that the impropriety of the demand may relate, or could be determined by reference to the underlying contract.

Although the convention does not pretend to have elaborated an exhaustive list of the grounds on which the fraud rule can rely and has some pitfalls, it undoubtedly provides an impressive guidance for courts to enhance their application of the fraud rule. The provisions of the convention provide an excellent international standard, as they are clear and narrow in scope.

Summary

As we have seen, the fraud rule is one of the most controversial and confused areas in the law governing demand guarantees. The inconsistency between the decisions of different courts illustrates the difficulty that they have to formulate a proper standard of fraud that will reflect a balance between all the different interests involved in a demand guarantee. Indeed, if the standard is set too low, a principal unwilling to pay will easily abuse the fraud rule. This will definitely affect the commercial utility of demand guarantees. On the other hand, if the standard is too rigid, it may encourage fraudulent maneuvers on the part of the beneficiary. Therefore, extreme standards of fraud such as egregious fraud and constructive fraud should be avoided as they represent only the

⁸⁴J Chuah., *op.cit.*, at 525.

interests of either the beneficiary or the principal.⁸⁵

A proper standard of fraud can be found by a combination of the provisions of art.5 UCC and art.19 Uncitral. This idea is best expressed in the words of Xiang:

‘Under the revised UCC art.5, section 109."material fraud" may invoke the fraud rule...the standard of material fraud has not only avoided extreme ideas such as egregious fraud and constructive fraud but has also reflected the unique nature of [demand guarantees]. Because material fraud is a general word the implementation of the standard of material fraud remains uncertain...This uncertainty may to some extent be reduced by recourse to the provision of art.19 of the Uncitral convention,...,where a detailed list of the types of misconduct that constitute material fraud has been provided.’⁸⁶

There are, however, some similarities between jurisdictions regarding the concept of fraud. Firstly, all jurisdictions agree that fraud could be determined by reference to the underlying contract; secondly, evidence of the beneficiary's fraudulent state of mind is not required; thirdly, the evidence of fraud must be clear, beyond reasonable doubt and must be produced immediately.⁸⁷

2.2 Evidence of fraud

It is trite law in commercial practice that evidence of fraud must be clearly established and beyond doubt, both as to the fact of fraud and as to the guarantor's knowledge; or in the words of Ackner L.J when fraud is invoked the only inference to be drawn by the court must be one of fraud. Mere allegations of facts, testimony, or documentation from the principal are insufficient. The reason of the high standard in respect of the evidence of fraud rests upon the fact that irreparable damage can be done not only to the bank's

⁸⁵G Xiang and R P Buckley, *op.cit.*, at 334.

⁸⁶*Idem.*

⁸⁷R Bertrams, *op.cit.*, at 353.

credit but also to the business reputation of the beneficiary accused of fraud. Lord Donaldson explained it in *Bolivinter Oil SA v. Chase Manhattan NA* as follows:

‘... [The] evidence must be clear, both as to the fact of fraud and as to the bank's knowledge. It would certainly not normally be sufficient that this rests on the uncorroborated statement of the customer, for irreparable damage can be done to the bank's credit in the relatively brief time which must elapse between the granting of such an injunction and an application by the bank to have it discharged.’⁸⁸

Following the judgment in *United Trading Corp SA v. Allied Arab Bank Ltd*,⁸⁹ the requirement of clear evidence of fraud can be broken down into various elements:

- There must be some corroboration of the allegation of fraud. It is insufficient for the principal to make mere allegation of fraud on affidavit;
- The beneficiary should be given a fair opportunity to answer the allegation and to have failed to provide any adequate answer in circumstances where one could be properly expected. Consequently, if the beneficiary is able to give an arguable justification, there will not be a case of fraud;
- The principal must be able to show that the only realistic inference is that the demand is fraudulent.⁹⁰

Furthermore, courts and legal writing (In Europe especially) have required that evidence of fraud must be produced immediately without in depth investigations in the underlying contract. It is said that this requirement agrees with the liquid function of demand guarantees. However, it seems that in extreme cases, this requirement -although laudable it may be- can lead to the protection of fraudulent beneficiaries. For instance, in complex and controversial legal issues, it can be extremely difficult for the principal to produce immediately evidence of fraud, partly because it will be totally normal for the fraudulent beneficiary to hide all evidences against him. This hurdle is even more complicated when allegation of fraud is made by the bank. There is thus a need to outweigh the

⁸⁸[1984] 1 Lloyd's Rep.251 at 257.

⁸⁹[1985] 2 Lloyd's Rep. 554.

⁹⁰D Warne. and N Elliott, *Banking litigation*, Sweet & Maxwe ll, 2005, at 263.

benefits of the liquidity function of demand guarantees to the risk of protection of fraudulent maneuvers from the beneficiary. The balance can be achieved in adopting the American approach. Indeed, the position in America allows a more in-depth and protracted investigation into the underlying contract, however such investigation should be done during a reasonable time regarding the circumstances of the case.

2.2.1 What must be proven?

Obviously, the principal must establish the facts that he alleges and demonstrate the legal consequences from these facts.⁹¹ For instance, in a case of perfect completion of the contract the principal must prove that he performed his obligation under the contract and that the beneficiary is therefore not entitled to damages or again if the contract was suspended by a case of force majeure the principal should prove the occurrence of the force majeure. In the case of forgery in documents, proof that the documents are not genuine must be furnished. It appears thus that the burden of proof is upon the principal and not the beneficiary.

2.2.2 Whose fraud matters?

The beneficiary must be a party to the fraud; it is only his fraud that can unravel his rights under the guarantee. In other words, even if the demand is fraudulent due for instance to a misrepresentation in the documents of which the beneficiary had no knowledge, the principal will not be able to make a case of fraud. Consequently, the bank will still be under the obligation to pay. This decision was reached in *United City Merchants (Investments) Ltd. and others v. Royal Bank of Canada and others* in which it was held:

‘The bank's duty to the seller was only vitiated if there was fraud on the part of the seller, and the bank remained under a duty to pay the amount of the credit to the seller even if the documents presented, although conforming on their face with the terms of the

⁹¹R Bertrams, op.cit, at 278.

credit, nevertheless contained a statement of material fact that was not accurate. Nor was the bank relieved from liability to the seller even if the document presented by the seller contained a material misrepresentation of fact which the person issuing the documents knew to be false and which was intended by him to deceive persons, including the seller himself, who might thereafter deal in the documents.⁹²

The requirement that fraud does not defeat the beneficiary's claim unless he had knowledge of the fraud before presentation of documents has helped to restrict the scope of the fraud exception.⁹³

2.2.3 What happens where the forged documents are not tendered by the beneficiary but an innocent third party, such as negotiating or discounting bank?

In *Discount Records Ltd. V. Barclays Bank Ltd*,⁹⁴ it was held that the fraud principle should not apply to such third party because they, as holder in due course of the bill of exchange, should not be made to suffer the consequences of the beneficiary's fraud. Consequently, when the forged documents are tendered by a third party the bank is still under the obligation to pay if the third party did not participate to the fraud or was not aware of it.

2.2.4 Time at which knowledge of fraud must be proved

There can be no doubt that the beneficiary must know of the fraud at the time of the call for payment, because absent such knowledge the beneficiary cannot be party to the fraud. However, it is arguable that the bank does not need to know of the fraud at the time of presentation. Supposing that at the time when payment is due a bank that has no more than a suspicion that there is fraud in the underlying transaction is nevertheless

⁹²[1982] 2 All E.R at 729.

⁹³N Enonchong, op.cit., at 418.

⁹⁴[1975] 1 W. L. R. 315.

confident that it will be able to produce clear evidence of fraud shortly afterwards. Is the bank entitled to refuse to pay when it has no evidence of fraud at the time of payment in the hope that such evidence will be available by the time of the hearing of the beneficiary's application for summary judgment? Or if the bank after rejecting the demand for payment on the ground of non conformity later discovers prior to the hearing that the beneficiary has committed a fraud at the time of the demand, is the bank entitled to rely on the fraud exception? In other words, should the bank's fraud defense fail because it had no evidence of fraud at the time of the presentation even though fraud is clearly established at the time of the hearing?

This question was addressed directly in *Balfour Beatty Civil Engineering v. Technical & General Guarantee Co. Ltd.*⁹⁵ This was an appeal from an application for summary judgment on a performance bond. The defense was that the beneficiary had no honest belief that there had been a default giving rise to the ability to make a valid presentation. The question arose as to what the position is if the bank has rejected at the time of presentation, without sufficient evidence of fraud, but subsequently the evidence becomes available. Waller LJ, with whom Swinton-Thomas LJ and Jonathan Parker J agreed, recognized that it would be absurd to think that the bank can have judgment entered against it because evidence of the fraud was not available at the time to the bank at the time of payment. The reason of such absurdity was given by Mance LJ in *Solo Industries UK Ltd v. Canara Bank*⁹⁶ According to him, the true explanation as to why a bank should be able to rely on evidence of fraud obtained after a demand for payment is that the court should not lend its process to assist fraud, "fraud unravels all". It would be irrational if the bank could not rely on the fraud exception if clear evidence of fraud becomes available only before the trial and not at the time of the demand, given that such exception is based on public policy.⁹⁷

⁹⁵[1999], 68 Con LR 180.

⁹⁶ [2001] 2 Lloyd's Rep 578[21].

⁹⁷D Warne and N Elliott, op.cit., at 262.

2.3 Possible types of fraud

This paragraph is a restrictive survey of the different circumstances that can lead to fraud on the part of the beneficiary. The starting point of this survey is contained in art.19 (1) (c) Uncitral Convention, according to which a demand for payment is fraudulent if it has no conceivable basis under the underlying contract. The burden of proof remains on the part of the party that invokes fraud; this can be either the bank or the beneficiary.

2.3.1 Completion of the contract

When there is completion of the contract by the principal and that the beneficiary makes a call for payment, such call may be considered as fraudulent having regard to the circumstances of the underlying contract. The hurdle in this case of fraud is for the principal to prove that he has perfectly performed his obligations under the contract. The judgment in *United Trading Corp. v. Allied Arab Bank*⁹⁸ illustrates which kind of evidence the principal will have to produce in order to successfully present his case before the court. Indeed, in this case Ackner LJ requires strong corroborative evidence of the allegation usually in the form of contemporary documents, particularly those emanating from the buyer. However, in a construction contract the principal can produce additionally engineers' certificates issued in the course of the construction projects.

Other factors that bear on the matter of evidence concern the existence of genuine different point of view between the principal and the beneficiary, and the conduct of the beneficiary. Therefore, absence of serious complaints on the part of the beneficiary can help to establish fraud.⁹⁹

⁹⁸[1985] 2 Lloyd's Rep. 554.

⁹⁹R Bertrams, *op.cit.*, at 282.

However, the fact that the contractual warranty period has elapsed does not forfeit the beneficiary's right to hold the principal liable because of certain provisions in the main contract neither does it relieve the principal of his burden of proof. On the other hand, protracted silence on the part of the beneficiary could suggest that his complaints are spurious.¹⁰⁰ In this therefore wise to decide each case on the basis of its own facts. The principal may have a valuable plea in case of non-completion of the underlying contract: When there is occurrence of a *force majeure*.¹⁰¹ Consequently, when there is a situation of force majeure, any demand made by the beneficiary will be considered fraudulent. Here, the principal will have to establish that the supervening events have occurred and that these events made the performance of the contract impossible. Impossibility must be established not just mere difficulties in the performance. Consequently, if the principal could have prevented non completion of the contract by adopting other means than those planned at the beginning of the contract, his plea will not be effective. A case decided on the basis of force majeure is *Dynamics Corp. of America v. Citizens & Southern Nat'l Bank*.¹⁰² The facts of the case were that Dynamics the plaintiff contracted a contract of sale with the Indian government for defense-related equipments. In accordance with the terms of the contract, Dynamics requested his bank to issue a standby letter of credit in favor of the Indian government. A short time after, war broke out between India and Pakistan rendering the execution of the contract impossible because of an embargo on military supplies to the region. The Indian government presented a draft in order to obtain payment under the letter of credit; subsequently the plaintiff filed a complaint for a stop- payment injunction alleging that he had perfectly performed the contract. The court acknowledged the fact that the demand of payment was indeed fraudulent because the occurrence of force majeure, in this case the U.S embargo, discharges the principal from liabilities under the contract.

¹⁰⁰Idem.

¹⁰¹The term force majeure is a French expression referring to an "exemption" or relief from liability clauses. A force majeure clause reflects a conscious decision that an event which is unforeseen and outside the control of both parties should provoke a fair sharing of risk.

¹⁰²356 F. Supp. 991 (N.D. Ga. 1973), resume extracted from G Xiang and RP Buckley, op. Cit., at 307

2.3.2 Breach of the fundamental obligation or serious misconduct on the part of the beneficiary

It is standard practice in international contracts to require the issuance of a letter of credit for the benefit of the principal as a prerequisite to the formation of the contract. Consequently, breach of this requirement entitled the principal to rescind the contract or suspend his obligations without incurring any liabilities, as technically there is no contract. Therefore, a call under such circumstances will be fraudulent considering that such call has no conceivable basis. Indeed, in *Garcia v. Page & Co. Ltd*¹⁰³ it was held that the buyer's duty to open a letter of credit in time is usually a condition precedent to the seller's duty to ship the goods. According to Porter J in his judgment in favor of the seller, where a date for the opening of the credit is stipulated in the contract, the buyer must comply with that date. Failure to do so is tantamount to a repudiatory breach that allows the seller to consider the contract as having been discharged.

Still in the context, a call could be considered fraudulent if performance of the contract by the principal has been made impossible due principally to the non-performance of the beneficiary of his obligations under the contract. For instance, failure to provide the necessary licenses for the completion of the work, failure to provide the labor if required by the contract, failure to provide down payment if agreed by the parties....In these cases the burden on the principal will be to prove that otherwise for his obligations that have been delayed because of the beneficiary, he has performed correctly the rest of his obligations.¹⁰⁴

2.3.3 Violation of public order and illegality

It is trite law that the underlying contract cannot relieve the bank from its duty under the guarantee. However, when the underlying contract violates public order the beneficiary

¹⁰³[1936] 55 Ll. LR. 391.

¹⁰⁴ R Bertrams, *op. cit.*, at 290.

cannot claim payment under it. Indeed, the court could not lend its process to help a violation of public order e.g. when the underlying contract relates to drug trafficking. However, the notion of public order must be construed narrowly as every country has its own notion of public policy. Allowing a broad concept of public policy will have the effect to infringe the utility and desirability of demand guarantees. Indeed, it will be absurd to expect of the beneficiary to be familiar of all that constitutes violation of public order in the principal's country. Therefore, public order must be understood as "international "public order.¹⁰⁵

Any call made in circumstances of illegality is also fraudulent. As with the case of public order, the notion of illegality must be measured by international standards. Here, two types of cases occurred: There are situations where the demand guarantee itself is illegal and where it is the underlying contract itself that is illegal. In the first situation, there is no difficulties payment must not be made.¹⁰⁶ An example of the second situation is provided in *Mahonia Ltd v. JP Morgan Chase Bank*¹⁰⁷ where Cooke J took the view of Colman J according to which illegality in the underlying contract can taint the letter of credit and thereby render it unenforceable. It is submitted that the claim for payment should be dismissed only if the principal contract is illegal under the applicable law and if the law governing the guarantee considers the kind of transaction manifestly illegal as measured by international standard.¹⁰⁸

¹⁰⁵Idem., at 296.

¹⁰⁶A demand guarantee may be illegal where the issue of the guarantee is prohibited or because of a supervening prohibition, see N Enonchong, op.cit., at 406.

¹⁰⁷[2003] EWHC 1927 (Comm.); [2003] 2 Lloyd's Rep 911.

¹⁰⁸R Bertrams, op.cit., at 296.

2.3.4 The call does not relate to the principal contract or is inspired by improper motives

An independent guarantee covers a particular risk contained in a particular contract. A demand for payment must relate to the risk apprehended in the contract and not for losses originated from other contracts. Consequently, a demand for payment in view of losses originating from other contracts, or the attempts to call all outstanding guarantees for a loss arising from just one of a series of contracts is considered fraudulent.¹⁰⁹

When a demand for payment is inspired by improper motives, the call will be treated as fraudulent. The bank is not entitled to pay when the beneficiary commits a manifest “abuse of law”. This is for instance the case when the beneficiary demands the guarantee with the intent to cause damage. It has been decided that when the beneficiary demands the guarantee with the clear intention to put the principal under the pressure to change the underlying contract or to review the case, there is manifest abuse of law.¹¹⁰ This is best illustrated in *Samwoh v. Sum Cheong Piling Pte. Ltd.*¹¹¹ Samwoh, the plaintiff, entered into a contract with Piling, the defendant, for the performance of some work on the site. The parties agreed that, upon Samwoh moving their equipment on the site, Piling would ensure the existence of proper drainage and fitness of the area for paving. As agreed, Samwoh moved a paving team on the site and carried out some work but complained that Piling had failed to perform his part of the contract so that it would be unreasonable for Samwoh to accept that the area was fit for them to carry out their work. Consequently, Samwoh stopped working, as Piling did not intend to remedy his part of the contract. Piling made a claim under the guarantee for non-performance of the contract by Samwoh. As a result of the demand, Samwoh sought an injunction in order to prevent Piling from drawing under the guarantee.

¹⁰⁹Idem, at 298.

¹¹⁰Hans Van Houtte, op.cit, at 315.

¹¹¹[2002] BLR 459 (Sing CA), resume extracted from A Ganotaki,

In its judgment in favor of the plaintiff, the Court of Appeal found that in the light of all circumstances of the case, Piling had acted unconscionably and in bad faith. The demand under the guarantee was abusive used by the defendant mainly as a means of forcing Samwoh to accept the terms under the contract.

CHAPTER 3: FRAUD AND THE POSITION OF THE BANK

Introduction

It is trite law that, because of the principle of independence, a bank in demand guarantee is obliged to pay the beneficiary when it is confronted by a compliant demand without regard to the situation in the underlying contract. However, if fraud on the part of the beneficiary is evident to the bank at the time of payment, the bank owes a duty to the principal to reject the demand and to refrain from payment. If the bank disregards this duty, it incurs liability towards the principal, which implies the forfeiture of its right of reimbursement under the contract of indemnity. The liability that the bank incurred derives from its duty to perform the contract of mandate between him and the principal in good faith and due care. Indeed, no one is entitled to assist in fraudulent practices by third parties.¹¹²

3.1 Duties of the bank

3.1.1 Duty of examination with respect to compliance with the terms and conditions of the guarantee

For the examination of documents presented under an international demand guarantee, the globally accepted principle of strict compliance applies. The meaning of this principle is that the duty of the bank is to make payment only against documents that comply strictly with the terms of the guarantee. Accordingly, if there are discrepancies between the documents, the bank is under a duty to reject them even though their material adequacy for the purposes of the underlying contract can be proven through

¹¹²R Bertrams, op.cit., at 397.

evidence outside the documents.¹¹³The bank will always have to ascertain whether the demand has been made in correct form and by the proper person and whether the beneficiary has submitted the statement of default (if so required by the guarantee). Additionally, the bank will have to verify if the demand has been made on or before the expiry date. (Art.19 URDG).¹¹⁴Failure by the bank to comply with these requirements will unravel its right of reimbursement under the counter indemnity and may expose it to a claim of damage from the principal. In *Equitable Trust Co. of New York v. Dawson Partners, Ltd.*¹¹⁵Lord Sumner has appropriately summarized the essence of examination in his statement:

‘It is both common ground and common sense that in such a transaction the accepting bank can only claim indemnity if the conditions on which it is authorized to accept are in the matter of the accompanying documents strictly observed. There is no room for documents which are almost the same, or which will do just as well.’

However, a mere visual inspection of the documents by the bank will suffice to determine that the documents are compliant. The bank is neither required to look beyond the documents to ascertain their compliance nor to check their authenticity (art.11 URDG). Thus, all a bank is to do is to determine, based on the documents alone, whether they appear on their face to comply with the terms and conditions of the guarantee. In determining whether the documents comply, the bank will have no regard to trade custom.¹¹⁶ The reason to narrowly bind the bank to the terms of the guarantee is based in the fact that the bank has no visibility of the relation between the parties in the

¹¹³J Nielsen and N Nielsen, ‘Standby letter of credit and the ISP98: A European perspective’, available at [http:// letterofcreditforum. Com/node/11](http://letterofcreditforum.Com/node/11), p. 18

¹¹⁴R Bertrams, op.cit.,at 136.

¹¹⁵[1927] 27 Ll. L. Rep.49,52.

¹¹⁶Indeed, allowing such discretion on the part of the bank would not only result to a waste of time but also to its involvement in the underlying contract.

underlying contract and due to lack of industry; experience cannot foresee what the results of a deviation to the order will have.¹¹⁷

However, at present the principle of strict compliance is somewhat softened. Consequently, bank does not have to insist on the rigid and meticulous fulfillment on the wording. A word-by-word compliance is only necessary if stipulated in the guarantee. Consequently, a one digit error in the number of a credit does not justify dishonor of the demand where the mistake is an obvious typographical or clerical error.¹¹⁸

To what standard are banks to be held in examining the documents?

The standard to which the banks are held when discharging their duty is embodied in art. 9 of the URDG:

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

This article, together with art.11 URDG reinforce the third of the three principles enshrined in art.2(b) URDG, that guarantors are not concerned with the adequacy, accuracy of documents presented to them, they are only required to exercise reasonable care to ascertain by visual examination if the documents appear on their face to conform.¹¹⁹

This follows the position of Ackner L.J in *United Trading Corporation SA v. Allied Arab Bank Ltd* where he stated:

¹¹⁷J Nielsen and N Nielsen, op.cit, at 14.

¹¹⁸ R A Hillman, *Common law and equity under the uniform commercial code*, Ghoram & Lamont, Boston, 1991, at 17-5.

¹¹⁹R Goode, op.cit., at 29.

‘...a bank owes a duty of care to the party ultimately liable at the end of the chain not to pay out on a performance bond if, on the information available to it, there is clear evidence that the beneficiary’s demand is fraudulent, because it is the party at the end of the chain who may have to bear the ultimate loss’.¹²⁰

Therefore, banks are not strictly liable if they fail to uncover discrepancies in the documents as long as they were acting with reasonable care. This means in other words that if the credit is ambiguous or unclear, the bank may need to clarify the matter with its customer, but if it does not see the need to, it commits no breach by adopting a reasonable interpretation.¹²¹ However, if there are obvious irregularities in the documents that a reasonable bank would have noticed, the bank will be liable for any payment made. As true as the standard of reasonable care affords protection to the bank against the risk of misinterpreting voluminous and intricate documents, it opens a gap of uncertainty in the realm of demand guarantee. Indeed, who is to determine that the bank acted with reasonable care and how is it measured? The URDG does not determine what constitutes "reasonable care". Currently, courts and legal writing have failed to provide a functional standard of document verification. As a result courts' decision relies on a case-by-case analysis according to each court’s own version of reasonableness consequently; such analysis does not lend itself to generalization. The lack of a functional standard of verification to be used in conjunction with strict compliance has resulted in a proliferation of credit litigation and in costly uncertainty throughout the demand guarantee world.¹²²

3.1. 2 Bank’s duty to examine within a reasonable time

Banks must examine the documents within a reasonable time. The length of the reasonable time depends on e.g. the need for urgency or the complexity and language of

¹²⁰[1985]2 Lloyd’s Rep. 554.

¹²¹R Cranston , *Principles of banking law*, 2d. ed., Oxford University Press, 2002, at 389.

¹²²Hapgood QC, op.cit.

the documents.¹²³ Normally, it takes two to three banking days to examine the documents submitted under the guarantee. Exceeding this time limit, the bank does not trigger any disadvantages, as it is not liable since there is not a fixed date for the payment under the guarantee. However, the lack of any sanctions when exceeding the standard examination time does not entitle the bank to postpone a refusal for payment when there are discrepancies in the document until the day of expiration. It is common practice in the banking area, for the bank to notify the beneficiary immediately, to permit this latter to take further measures.¹²⁴ Consequently, failure for the bank to act within a reasonable time will seriously damage its international reputation.

3.1.3 Bank's duty of notification of the demand for payment

The main purpose of the notification is the announcement of the bank to the principal that the beneficiary has placed a demand under the guarantee and that consequently the claim for reimbursement of the guarantee now becomes due. So, the applicant shall have the time to attune to the imminent debit to his account or advise the bank which funds to use to honor the guarantee.¹²⁵ However, in a case of plausible fraud the importance of notification has a side effect. It is common ground that the only possibility for the principal to obtain a preliminary stop-payment order is his ability to establish fraud on the part of the beneficiary. Should, however, payment by the bank already have been effected, his chances of reimbursement of the money debited from his account will be if he can prove not only fraud by the beneficiary but also knowledge of such fraud by the bank at the time of payment. As already discussed above, in such situation his chances of success are very small due to the high standard of proof. Consequently, it is crucial

¹²³ Contrary to the UCP, the URDG does not impose a time limit for the examination of the documents. Indeed, according to art. 13(b) UCP the reasonable time for the examination of documents must not exceed seven banking days following the day of receipt of the documents.

¹²⁴ J Nielsen and N Nielsen, *op. cit.*, at 18.

¹²⁵ *Idem* at 17.

for the principal to be aware of a demand so that he can take the required steps for an interlocutory relief.¹²⁶

The question of whether the bank has a legal duty of notification towards its customer, the principal, has been long debated in the legal environment but still a unanimous view on the subject has not emerged. In the United Kingdom, a general duty of notification has been rejected. Although it has been a long standing practice for the bank to give prior notification to their customer for the safeguard of their relationship, the court in *Esal (Commodities) Ltd. v Oriental Credit, Wells Fargo*¹²⁷ found that this custom does not amount to a legal obligation on the part of the bank. The position would obviously be different if, according to the terms of the mandate, the bank had expressly agreed to inform its customer before making payment. Indeed, in such a case the bank would be exposed to liability if it breaches its contractual obligation. In Germany, however, the position is different from the one in the United Kingdom. Indeed, according to the BGH adjudicating a suretyship payable on first demand the notification serves to give the applicant to present facts, which would prevent the bank from payment. Accordingly, the BGH did not negate the bank's duty to notify. The bank however, does not have to insist or wait for a response from the applicant.¹²⁸ The position is the same in the United States as well, where there exists a so-called "notice injunction" requiring the bank to inform the account party of the demand for payment and to allow a period of ten days before honoring the demand.¹²⁹

Art.17 URDG requires the bank to inform the account party of the demand for payment without delay; however, it does not require the bank to notify the account party before paying. Accordingly, the bank will not be liable if it receives a demand for payment and pays it the same day whilst in the meantime it notifies the bank that it had received and

¹²⁶R Bertrams, op.cit., at150.

¹²⁷[1985] 2 Lloyd's Rep. 546 (QB).

¹²⁸J Nielsen and N Nielsen, op.cit., at 17 .

¹²⁹R Bertrams, op.cit., at 151.

honored a demand for payment.¹³⁰ This position seems to be the best since a demand under the guarantee will rarely come as a surprise to the principal who will have thus enough time to prepare his case.

3.2 Bank's liability in after payment cases

3.2.1 Direct guarantee

3.2.1.1 Distinction between "before" and "after" payment case

It is important to draw a distinction between before and after payment cases, as the significance of the recourse of the principal before the court differs in each case. Indeed, in "before" payment cases the principle is that if fraud is evident to the bank, the bank must refrain from payment. In this case, the significance of the proceeding against the bank is to obtain a restraining order, which will prevent payment by the bank in cases of established fraud. (This aspect will be analyzed in more detail in chap.4) However, in the "after" payment cases the principle is that the bank is liable when it proceeded to payment while the beneficiary's fraud was evident to it. This situation becomes relevant when the bank has already paid the beneficiary and seeks reimbursement from a principal that argues that the bank should not have paid. Here, the significance of the proceeding against the bank is to establish its liability. Concerning this proceeding, it has been proved very difficult to establish the liability of the bank, especially in a case of indirect guarantee.¹³¹

The rule that the bank must refrain from payment if fraud is evident to it, does not imply a duty of the bank to enquire or to decide on the impropriety of the beneficiary's call. It

¹³⁰ Idem, at 154.

¹³¹ Idem, at 306

is the principal's responsibility to adduce clear evidence of fraud as far as the call is concerned. This principle was put this way in *Turkiye Is Bankasi v. Bank of China*:¹³²

‘It is simply not for the bank to make enquiries about the allegations that are being made by one side against the other. If one side wishes to establish that a demand is fraudulent it must put the irrefutable evidence in front of the bank. It must not simply make allegations and expect the bank to check whether those allegations are founded or not’.

The bank's only duty is to act in good faith, which is a subjective requirement. Accordingly if the bank determines that the evidence is insufficient, it is entitled to pay in its relationship with the principal.¹³³

3.2.1.2 Bank's knowledge of the beneficiary's fraud

The bank must have knowledge of the beneficiary's fraud when it makes payment for it to incur liability. However, it is impossible for the bank to have a constructive knowledge of fraud unless the principal produces convincing evidence before payment. As Bertrams puts it:

‘The fraud must be clear and unambiguous such that the ordinary, prudent, and diligent bank ought to have appreciated, on the strength of the material before it, that the beneficiary's call was fraudulent ...In other words, the [principal] might not have left the bank with any doubts in respect of the impropriety of the beneficiary's call. This is a very severe test, and there is no room for laxness in favor of the [principal].’

Courts are very hesitant to give judgment against the bank as; ordinarily the bank is unable to determine the existence of fraud.

If the bank makes payment, and it subsequently transpires that in a document there was fraud the bank will still be entitled to debit the principal's account. The position is the same, if although warned by the principal of a fraudulent demand the bank honored its

¹³²[1999] 2 Lloyd's Rep. 611.

¹³³R Bertrams., op.cit., at 399.

commitment and it appears subsequently that the call was fraudulent. Indeed, the bank is obliged to withhold payment only in circumstances of established fraud; in other circumstances, the bank has a discretionary power provided that it acts in good faith.

3.2.1.3 Appraisal and suggestion for an alternative set of rules

The bank faces a very serious dilemma if its customer, who instructed it to issue the guarantee, subsequently instructs the bank not to pay if it receives a claim from the beneficiary. The fact that the bank has to use its discretion to determine if the principal has adduced clear evidence of material fraud put it in a very awkward situation, since in most cases it is difficult for the bank to distinguish between a fraudulent activity and mere inaccuracies in the documents or simple contractual different. On the one hand, if the bank decides to honor its commitment under the guarantee and effect payment and it appears that there is a case of fraud, the principal may refuse to reimburse the bank and subsequently the bank may lose a valuable customer; on the other hand if the bank does not pay, it faces the danger that the beneficiary under the guarantee may issue summons against it claiming damages if it is established that there is no fraud on his part. Moreover, its international reputation would be severely damaged.¹³⁴ It seems not only unfair to burden the bank with such a great responsibility, but also inappropriate to allow the principal to leave the prevention of fraud in the hand of the bank.

An alternative set of rules that accommodates the legitimate interests of the bank and customer has been suggested by banking practice. It is submitted that the bank is not liable to the principal in case of fraud if it notifies the principal of the demand for payment made by the beneficiary and consequently postpones the payment for a few days. Usually the bank insists on the principal to obtain an injunction either preventing the bank itself from paying out or preventing the beneficiary from the drawing on the guarantee until the question of fraud has been tried. If the principal fails to take any judicial actions, the bank is entitled to proceed to payment without risks of liability. This

¹³⁴AB Fourie , The banker and the law, the institute of bankers in South Africa, 1993; R Bertrams, op.cit., at 400.

is in accordance with the provisions of art. 19 Uncitral Convention that entitle the bank to withhold payment and art. 20 Uncitral Convention that permits the principal to obtain a restraining order against the beneficiary and/or the bank. This solution is more workable as it avoids the transfer of loss from the principal to the bank while the beneficiary is still in possession of the proceeds he should not have received, as in the case of liability in the part of the bank.¹³⁵

Another way of solving the matter is through "payment under reserve and indemnities". A bank that has serious doubt as to the allegations of fraud may make payment under reserve, especially where the beneficiary is a valued customer of good standing. The principle underlying the payment under reserve is that the beneficiary is bound to repay the money if fraud is subsequently established by the courts. Rather than making payment under reserve, the paying bank may ask the beneficiary to supply an indemnity either through the beneficiary himself or through his bank.¹³⁶

3.2.2 Indirect guarantee

3.2.2.1 Issuing bank's liability

The principle of liability applies indifferently whether it is a direct guarantee or an indirect guarantee. However, since there is no contractual relationship between the principal and the issuing bank, the duty that the issuing bank owes, is founded on the general duty of care and the principle of good faith.

3.2.2.2 Instructing bank's liability

If the principal estimates that the instructing bank should not have reimbursed the issuing bank, after this latter has already made payment to the beneficiary, because of alleged fraud then the principal must prove not only the beneficiary's fraud and the

¹³⁵R Bertrams, at 401.

¹³⁶P Sellman , op.cit., at162.

issuing bank's knowledge of such fraud at the time of payment but also the instructing bank's awareness of fraudulent activities at the time of honoring the counter-guarantee. The burden of proof put upon the principal seems so heavy that it tends to render the notion of fraud a myth in this case.

3.3 Banking practice

Even though in many jurisdictions, the legislations have limited the involvement of the bank in cases of fraud by narrowing the scope of their duty, banks tend to intervene when the interests of their customer are at stake. Especially, if presented with plausible evidence of fraud. Such behavior on the part of the bank is motivated by the need to not strain its relationship with those who are of vital importance to the bank's survival. Consequently, banks are often willing to postpone payment, to act as an intermediary between the principal and the beneficiary and to assist in attempts to sort out misunderstandings or difference of opinions. It may happen that banks go as far as urging their customer to obtain a stop-payment injunction so that they can legally justify their refusal to pay.¹³⁷ However, if the beneficiary insists on payment, the bank is obliged to honor its commitment as long as fraud is not clearly established.

¹³⁷R Bertrams, *op.cit.*, at 403.

CHAPTER 4: STOP-PAYMENT ORDERS ON THE GROUND OF FRAUD

Introduction

When confronted with an unfair call on the independent guarantee, the principal debtor may apply either for an injunction to block payment by the bank or for an injunction to prevent the beneficiary from making claim for payment under the guarantee.¹³⁸ This injunction is normally sought before any litigation on the substantive issue between beneficiary and principal begins and as such is known as a pre-trial injunction or an interim injunction.¹³⁹ The assessment by the court of such application is delicate. Indeed, while there is a legitimate interest for the principal that no payment is made; the independent and unconditional nature of the guarantee should however not be denied. As a result, courts are generally not ready to interfere with the independent nature of the guarantee and thus grant injunction to restrain drawing or payment only in exceptional cases. Indeed, it is now a rule that a stop-payment order is only granted when the fraud is obvious, clearly established and beyond reasonable doubt.

To obtain an injunction the principal must satisfy the Court of a number of matters. Firstly, that he has a good arguable case against the party he is seeking to injunct that

¹³⁸Article 20 UNCITRAL Convention: (1) Where, on an application by the principal/applicant or the instructing party, it is shown that there is a high probability that, with regard to a demand made, or expected to be made, by the beneficiary, one of the circumstances referred to in subparagraphs (a), (b) and (c) of paragraph (1) of article 19 is present, the court, on the basis of immediately available strong evidence, may:

- (a) Issue a provisional order to the effect that the beneficiary does not receive payment, including an order that the guarantor/issuer hold the amount of the undertaking, or
- (b) Issue a provisional order to the effect that the proceeds of the undertaking paid to the beneficiary are blocked, taking into account whether in the absence of such an order the principal/applicant would be likely to suffer serious harm.

¹³⁹J Chuah , op.cit., at 491.

involves showing a clear case of fraud to the knowledge of the party to be enjoined. Secondly, the principal must establish a cause of action against the party he is seeking to enjoin. This may be achieved through the contract governing the relationship between the parties. However, a cause of action between the principal and the issuing bank can be achieved only through the issuing bank's duty of care in tort since there is no contractual relationship between them. Thirdly, the court must be satisfied that it has jurisdiction over the party against which the injunction is sought and finally the court needs to be ensured that the grant of the injunction will be a correct exercise of the court's discretion after considering the balance of convenience.¹⁴⁰

4.1 Direct guarantee

4.1.1 Restraining order against the beneficiary

The essence of this application is to prevent the beneficiary to present a demand or to draw under the demand guarantee on the basis that such demand is fraudulent. Compared to applications for stop-payment orders against the bank, the possibilities of success in restraining orders against the beneficiary are more promising. Indeed, in such proceedings, the position of the bank need not to be considered i.e. there is no need to prove that fraud was evident to the bank at the time of payment; moreover, the incursion of the principle of independence is less problematical. However, apart from the fact that in the proceeding against the bank other aspects may be considered, the circumstances that render a demand fraudulent, as well as the requirements in respect of evidence and the balance of convenience are the same in both procedures.¹⁴¹

Indeed, in *Czarnikow-Rionda Sugar Trading Inc. v Standard Bank London Ltd*,¹⁴² Rix J., in refusing to grant an injunction to restrain the beneficiary from making a demand,

¹⁴⁰P Sellman., op.cit., at159.

¹⁴¹R Bertrams , op.cit., at 314.

¹⁴²[1999] 1 ALL E.R. (comm.) 890.

said that the policy reasons for restricting the scope of the fraud exception must apply equally to injunctions sought against the beneficiary as they do to applications against the bank. Therefore, even where the application is against the beneficiary rather than the bank, the principal will have to satisfy the balance of convenience. This is an insuperable difficulty especially when the beneficiary is a large company with substantial assets within the jurisdiction. Indeed, in *State Trading Corp of India Ltd v. ED & F Man (Sugar) Ltd*¹⁴³ Lord Denning said that even if fraud was established, he would have refused an injunction because the beneficiary, a very old-established firm of sugar dealers in England, was financially sound and would have been able to meet any damages which might have been awarded against them, if the call was fraudulent.

In *Themehelp Ltd v. West and Others*,¹⁴⁴ the Court of Appeal had to consider the grant of an injunction on the application of the principal to restrain beneficiaries from drawing on a demand guarantee issued to secure an installment of the price payable under a share sale agreement. The grant of the injunction was on the ground that:

- the grant of an injunction did not threaten the principle of independence of the performance guarantee;
- the judge had been entitled on the evidence to find a prima facie case that the principal had been induced to enter the agreement by fraud;
- a freezing injunction over the proceeds of the beneficiaries would not have been sufficient;
- the beneficiaries were fully protected because the principals were solvent.¹⁴⁵

4.1.2 Restraining order against the bank

In applications for restraining orders against the bank, the cause of action is the bank's (imminent) breach of duty to desist from payment if the beneficiary's fraud is evident to

¹⁴³[1981] Com LR 235.

¹⁴⁴[1996] QB 84, [1995] 4 ALL E.R 215, CA..It is interesting to note that the majority in this case suggested that there should be a distinction between an injunction to restrain the beneficiary from making a demand and an injunction to prevent the bank to pay.

¹⁴⁵QC Hapgood, op. cit, at 738.

the bank. Proceedings for preventive stop-payment orders against the bank aim at the prevention of a wrong by the beneficiary. In these applications, the principal is not necessarily required to adduce evidence of the bank's knowledge of the beneficiary's fraud; as such, evidence is only relevant in after-payment cases where the liability of the bank towards the principal is in issue.¹⁴⁶

In *Bolivinter Oil SA v. Chase Manhattan Bank*,¹⁴⁷ the Court of Appeal made the following observations on the grant of injunction to restrain payment against the bank:

‘The unique value of such letter, bond or guarantee is that the beneficiary can be completely satisfied that whatever disputes may thereafter arise between him and the bank's customer in relation to the performance or indeed the existence of the underlying contract, the bank is personally undertaking to pay him provided that the specified conditions are met. In requesting his bank to issue such a letter, bond, or guarantee, the customer is seeking to take advantage of this unique characteristic. If, save in the most exceptional cases, he is to be allowed to derogate from the bank's personal and irrevocable undertaking, given be it again at his request, by obtaining an injunction restraining the bank from honoring that undertaking, he will undermine what is the bank's greatest asset, however large and rich it may be, namely its reputation for financial and contractual probity. Furthermore, if this happens at all frequently, the value of all irrevocable letters of credit and performance bonds and guarantees will be undermined. Judges who are asked, often at short notice and ex parte, to issue an injunction restraining payment by a bank under an irrevocable letter of credit or performance bond or guarantee should ask whether there is a challenge to the validity of the letter, bond or guarantee itself. If there is not or if the challenge is not substantial, prima facie no injunction should be granted and the bank should be left to honor its contractual obligation, although restrictions may well be imposed upon the freedom of the beneficiary to deal with the money after he has received it. The wholly exceptional case where an injunction may be granted is where it is proved that the bank knows that

¹⁴⁶R Bertrams, op.cit., at 320.

¹⁴⁷ [1984]1 ALL E.R 351n, [1984] 1 WLR 392, CA .

any demand for payment already made or which may thereafter be made will clearly be fraudulent.’

There are two major hurdles that the principal must clear before obtaining an injunction to restrain payment against the bank:

- To establish a serious issue to be tried that the fraud exception applies; and
- To establish that the balance of convenience is in favor of the grant of an injunction.

The circumstances in which both propositions can be established are exceedingly rare. For instance in *United Trading v. Arab Allied Bank*, the application for restraining order was dismissed because the beneficiary's fraud was not established and because the balance of convenience, as between the principal and the bank, tipped heavily in favor of the latter.

In respect of the first condition, the principal must make out a sufficient case of fraud in such an extent that the only realistic inference to draw is that of fraud. This requires that at an interlocutory stage the principal must show that there is real prospect of fraud, which is very difficult.¹⁴⁸ As to the balance of convenience (commonly called balance of hardships in the United States), the House of Lords in *American Cyanamid Co v. Ethicon Ltd*¹⁴⁹ explained the test to be applied as follows:

‘Unless the material available to the court at the hearing of the application for an interlocutory injunction fails to disclose that the claimant has any real prospect of succeeding in his claim for a permanent injunction at the trial, the court should go on to consider whether the balance of convenience lies in favor of granting or refusing the interlocutory relief that is sought. As to that, the governing principle is that the court should first consider whether, if the claimant were to succeed at the trial in establishing his right to a permanent injunction, he would be adequately compensated by an award of damages for the loss he would have sustained as a result of the defendant's continuing to do what was sought to be enjoined between the time of the application and the time of

¹⁴⁸See for further explanation Chapter 2.2 on the evidence of fraud.

¹⁴⁹[1975] 1 ALL E. R. 504.

the trial. If damages in the measure recoverable at common law would be adequate remedy and the defendant would be in a financial position to pay them, no interlocutory injunction should normally be granted, however strong the claimant's claim appeared to be at that stage. If, on the other hand, damages would not provide an adequate remedy for the claimant in the event of his succeeding at the trial, the court should then consider whether, on the contrary hypothesis that the defendant were to succeed at the trial in establishing his right to do that which was sought to be enjoined, he would be adequately compensated under the claimant's undertaking as to damages for the loss he would have sustained by being prevented from doing so between the time of the application and the time of the trial. If damages in the measure recoverable under such an undertaking would be an adequate remedy and the claimant would be in a financial position to pay them, there would be no reason upon this ground to refuse an interlocutory injunction.'

In practice, the balance of convenience will nearly always favor a refusal of the injunction because:¹⁵⁰

- If the injunction is granted in circumstances where the fraud exception is not subsequently made out at trial, the bank will have suffered damage to its reputation which will be irreparable and incapable of precise quantification; whereas
- If the injunction is refused, but the applicant does establish the fraud at trial, he will have suffered no loss since the bank's claim of reimbursement will fail.¹⁵¹

¹⁵⁰However in the US it is not very difficult for the principal to satisfy the balance of convenience. As a result, US courts have been able to grant injunctions in many cases in spite of this test. E.g. *Itek Corp. v. First National Bank in Boston* (1981) 511 F Supp 1341. See for further discussion N Enonchong, 'The problem of abusive call on demand guarantee', [2007] *LMCLQ* 1-128, February, 2007, at 87.

¹⁵¹QC Hapgood ., op.cit. at 736.

Therefore, even when a principal can make a sufficient case of fraud if, the balance of convenience does not tip on his behalf the court will not grant a restraining injunction. This illustrates the reluctance of the court to interfere with the autonomy of the demand guarantee.

An alternative solution might be for the principal to apply for a freezing injunction (previously known as a Mareva injunction) or a conservatory attachment (this terminology is frequently used in Continental law) restraining the beneficiary from using the funds he has received from the guarantee (art. 20(1) (b) Uncitral Convention). This solution has the advantage of not derogating from the sacrosanct principle of independence. Indeed, with the freezing order the bank is not freed from its separate and distinct contractual duty to honor the undertaking, thus preserving good commercial sense.¹⁵² However, the courts are extremely reluctant to grant such an order in respect of the proceeds of a performance guarantee payable abroad.¹⁵³

4.2 Indirect guarantee

The situation in case of indirect guarantee is more complex than in respect of a direct guarantee as not only the instructing bank, the beneficiary and the principal are involved but also the foreign issuing bank. In such a situation, it is advisable to the principal to initiate the proceedings not only against the instructing bank but also against the issuing bank. In respect of the issuing bank, the principal can apply for a restraining order against that bank from demanding or receiving payment under the counter- guarantee; or from honoring its obligation towards the beneficiary.¹⁵⁴

¹⁵²J Chuah, op.cit., at 521.

¹⁵³*Intraco Ltd v. Notis Shipping Corp (the Bojha Trader)*[1981] 2 Lloyd's Rep 256.

¹⁵⁴R Bertrams, op.cit, at 322.

4.2.1 Restraining orders against the instructing bank and/or the issuing bank in "after" payment case

The purpose of such application is to prevent the instructing bank from paying the issuing bank under the counter-guarantee or to prevent the issuing bank from making a demand of reimbursement to the instructing bank after honoring its obligation to the beneficiary because such demand will be fraudulent. There are thus two separate actions, the first is against the instructing bank in order to prevent payment from being made and the second is against the issuing bank in order to prevent it from making a demand under the indemnity agreement with the instructing bank on the basis of fraud.

In such applications, the position of the issuing bank plays a primordial role. Indeed, it is not the fact that the beneficiary made a fraudulent call under the primary guarantee that renders the issuing bank's call under the counter-guarantee fraudulent but it is the fact the issuing bank had actual knowledge of such fraud on the part of the beneficiary that renders its call fraudulent. Therefore, the demand for reimbursement on the counter-guarantee is fraudulent only if the issuing bank was involved in the beneficiary's fraud or it was aware of the fraudulent practices by the beneficiary at the time of payment.¹⁵⁵ In almost every conceivable case, this will be impossible to prove. Here, the position of the issuing bank is much the same than that of the instructing bank in a direct guarantee. Indeed, for the principal to make a sufficient case of fraud he will be obliged to present irrefutable evidence that the issuing bank had, or must have had, knowledge of the beneficiary's fraud when honoring its obligation.

The principal has thus a double burden of proof; he must first adduce clear evidence of fraud on the part of the beneficiary and then prove that the issuing bank knew about it at the time of payment. It is only then that the issuing bank will be liable and that the court would consider the grant of a restraining order against the issuing bank. The reverse is that if the issuing bank did not have knowledge of the beneficiary's fraud at the time of

¹⁵⁵ *Idem*, at 325.

payment it will not be liable and it will be entitled of reimbursement under the counter-guarantee.

4.2.2 Restraining orders against the instructing bank and/or the issuing bank in “before” payment cases

The situation here is when the issuing bank has not yet proceeded to payment under the primary guarantee when it calls the counter-guarantee. Thus, the purpose of such proceedings is to prevent the beneficiary from demanding or receiving payment under the primary guarantee. Here, as in the case of restraining order in before payment in direct guarantee, the principal does not have to adduce evidence of the issuing bank's knowledge of fraud on the part of the beneficiary as such applications are not meant to determine the liability of the issuing bank but to prevent it to honor its obligations because of the fraudulent actions of the beneficiary.

The true difficulties with respect to restraining orders against the foreign issuing bank and the beneficiary concern the jurisdiction of the courts in the principal's country and the recognition of judgments in the beneficiary's country.¹⁵⁶ The question of the jurisdiction *ratione materiae* of the courts in the principal's country over the issuing bank is very controversial in the area of demand guarantee and still there is not a unanimous decision concerning this question. However, it should be noted that one of the reason why the beneficiary insists on the involvement of a bank in his own country, is that any proceedings concerning the guarantee will take place in his own country so that he will have the advantage of a familiar jurisdiction.

Secondly, it is highly unlikely that a restraining order issued in the principal's country against the issuing bank and restraining order against the beneficiary will be recognized abroad i.e. in the beneficiary's country which is the country of the issuing bank. Indeed, the court will generally decline to recognize the order of a foreign court restraining

¹⁵⁶Idem, at 328.

payment under the guarantee. This is illustrated by *Power Curber International Ltd v. National Bank of Kuwait SAK*,¹⁵⁷ where although the Court of Appeal acknowledge that, wherever possible, it would seek to recognize and uphold the order of the court of a friendly state in the interest of comity, refused to recognize a "provisional attachment" of sums payable to the claimant by the defendant bank granted by a Kuwaiti court. The Court of Appeal instead granted the claimant summary judgment. The practical result of the non-recognition of such restraining order in the issuing bank is that the issuing bank is exposed to the considerable risk that it will be not be able to invoke such judicial orders as a valid defense against the beneficiary. Consequently, the issuing bank incurs a great risk of damaging its reputation. In order to protect the issuing bank in such situations, the courts in the principal's country should require that the evidence concerning the beneficiary's fraud is of such a nature that the issuing bank has a valid defense in his own jurisdiction against payment under the primary guarantee.¹⁵⁸

The above discussion illustrates why the Courts are reluctant to grant restraining orders in the case of not only direct guarantee but also even more in the case of indirect guarantee. Indeed, the interest in the integrity of the banking contracts under which banks make themselves liable on their guarantees is so great that not even fraud can be allowed to intervene unless the fraud comes to the notice of the bank (instructing or issuing bank as the case may be) in time and in such a way that it can be said that the bank had knowledge of the fraud. Furthermore, the necessity of a workable standard of evidence of fraud appears again especially in the case of indirect guarantee for the protection of the issuing bank. Although it cannot be said that a court would never grant an injunction to restrain payment under a demand guarantee, it would take extraordinary facts to surmount the difficulty arising from balance of convenience.

¹⁵⁷[1981] 3 ALL E. R 607, [1981] 1 WLR 233.

¹⁵⁸R Bertrams, op.cit., at 330.

CONCLUSION AND SUGGESTIONS

The requirement to provide demand guarantees and standby facilities in support of contractual obligations will continue to be an important factor in international trade. These instruments enjoy an enormous popularity with overseas traders as well as bankers who are constantly refining the documentation used, in order to satisfy market needs. Such popularity is the consequence of a particular advantage that has to offer demand guarantees: the independence of all the contracts involved in a demand guarantee. (Principle of independence or autonomy). Whether such instruments maintain this popularity will depend largely upon the attitude of the courts, and their willingness to enforce contractual undertakings according to their terms.¹⁵⁹

However, there is a one most recognized exception in the autonomy principle of a demand guarantee: The exception of fraud or *exceptio doli*. The exception of fraud is part as well of the Civil Law as of the Common Law tradition. The problem is that such exception cannot be recognized by the law too easily as such exception could also misuse and destroy the economic function of bank guarantee as dependable securities in international trade and finance.¹⁶⁰ Therefore, it appeared to us primordial to establish a standard that will reflect a sensible compromise between the importance of maintaining the principle of autonomy of demand guarantees and the importance of discouraging or suppressing fraud in demand guarantees. In other words, a proper standard of fraud that should legally serve the purpose of the fraud rule and be workable for the courts; and that commercially should facilitate the utility of demand guarantees. In accordance with Xiang and Buckley, it seems that the best solution to define the limit of the fraud exception is a combination of the provisions of the new U.C.C article 5, section 109 and those of article 19 of the UNCITRAL Convention.

¹⁵⁹G Penn, op.cit., at 289.

¹⁶⁰N Horn, op. cit. at 200.

The UCC establishes the standard of material fraud as the one that may invoke the fraud rule avoiding in this way extreme standard of fraud and reflecting at the same time the unique nature of demand guarantees. However, as the term "material" is a general term that may lead to different interpretation in different courts it is wise to combine it with the provisions of article 19 of the UNCITRAL Convention that provide a detailed list of the types of misconduct that constitute material fraud.¹⁶¹

Another problem that appears throughout this study is that it seems that only limited protection is available to the principal under the fraud rule not only because of the different standards of evidence of fraud but also because of the stringent test of balance of convenience. A way of filling that protection gap is for the courts to adopt a more interventionist position by shifting from the fraud exception to the possibility of having further ground of injunction. To this effect, Enonchong suggests the recognition of two more devices to combat the problem of abusive call, namely: "the underlying contract exception" and "the unconscionability exception".¹⁶²

The reason in favor of the underlying contract exceptions is that when a beneficiary has given an undertaken in the underlying contract not to call on the guarantee unless certain conditions are satisfied, he should not be allowed to hide behind the autonomy principle in order to break his promise. As to the unconscionability exception; it comes as a last resort since it is more flexible and allows the court to intervene in situations where intervention would be refused under the fraud exception or the underlying contract exception.¹⁶³ However, the scope of such exceptions should be kept within clear and limited boundaries.

This study focused as well in the discretionary power that has the bank to refuse payment when it considers that the demand for payment is improper or that there is a

¹⁶¹G Xiang and P Buckley, *op. cit.*, at 334.

¹⁶²N Enonchong, 'The problem of abusive calls on demand guarantees', [2007] *LMLQ* 1-128, February 2007, at 88.

¹⁶³E.g. *GHL Pte Ltd v. Unitrack Building Construction Pte Ltd* [1999] 4 SLR 604.

strong allegation of fraud on the part of the beneficiary by the principal. Indeed, the Convention introduces a slight degree of flexibility in the obligation of the guarantor, the bank. After, the introduction of Article 19 Uncitral Convention, guarantors may decide on their own responsibility whether there can be application of the fraud rule. After analysis, it seems to us that this rule with its high level of freedom and responsibility can also be inconvenient. Indeed, the norm introduced by the convention interrupts a quiet landscape in which payment on facial conformity of the demand with the guarantor is the general rule and non-payment is the exception. Now, the bank is placed in an ambiguous situation, indeed it has to exercise extreme care in order to avoid liability if the court finds the existence of fraud and thus exposes even more its international reputation.

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