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Roy Goode

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# **SYMPOSIUM NEW DEVELOPMENTS IN THE LAW OF CREDIT ENHANCEMENT: DOMESTIC AND INTERNATIONAL**

## **ABSTRACT PAYMENT UNDERTAKINGS IN INTERNATIONAL TRANSACTIONS**

*Roy Goode\**

### **I. GENERAL CONSIDERATIONS**

#### *A. Introduction*

In the Middle Ages, long before the advent of national commercial law, there had developed under the influence of the Italian merchants an increasingly systematised body of rules based on commercial custom and practice and administered by the merchants courts. Over time, this became received throughout Europe, giving rise to a cosmopolitan *lex mercatoria*, which not only contained rules for typical business transactions, but also addressed cases in which the dispute contained a foreign element, thus laying the foundations of modern private international law. With the rise of the nation state, commercial law became increasingly domestic in character; and even today, when English lawyers or French lawyers speak of the law of international trade, what they mean is the English law of international trade or the French law of international trade.

But the past 30 years have witnessed a resurgence in the

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\* Norton Rose Professor of English Law in the University of Oxford and Fellow of St. John's College, Oxford.

idea of a truly international *lex mercatoria*, distinguished from domestic law by the label "transnational commercial law." Principal among the international organisations that have contributed to the drive toward harmonisation of commercial law are the United Nations Commission on International Trade Law (UNCITRAL), the International Institute for the Unification of Private Law (UNIDROIT), the Hague Conference, the International Chamber of Commerce (ICC) and the European Community (EC). These and other organisations have used a variety of instruments to promote greater uniformity in international trade transactions. They include binding instruments, such as conventions and directives; facultative instruments, such as model laws and uniform rules; private institutional rules and formulations of trade terms which are given effect by contractual incorporation; advisory opinions; and codifications of contract law by scholars from many jurisdictions.

Two fields of commercial activity in which harmonisation measures have been particularly vigorous are transport and banking. This paper is concerned with the latter. In the past seven years alone we have seen new revisions of the ICC's INCOTERMS,<sup>1</sup> Uniform Customs and Practice for Documentary Credits (UCP),<sup>2</sup> and Uniform Rules for Collections;<sup>3</sup> formulations of new Uniform Rules for Demand Guarantees (URDG)<sup>4</sup> and ICC Model Forms for Contract Bonds,<sup>5</sup> the UNIDROIT Conventions on International Factoring<sup>6</sup> and International Financial Leasing,<sup>7</sup> the U.N. Convention on International Bills of Exchange and International Promissory Notes<sup>8</sup> and the UNCITRAL Convention on Independent Let-

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1. INTERNATIONAL CHAMBER OF COMMERCE, PUB. NO. 460, INCOTERMS (1990).

2. INTERNATIONAL CHAMBER OF COMMERCE, PUB. NO. 500, UNIFORM CUSTOMS AND PRACTICE FOR DOCUMENTARY CREDITS (1993) [hereinafter U.C.P.].

3. INTERNATIONAL CHAMBER OF COMMERCE, PUB. NO. 522, UNIFORM RULES FOR COLLECTIONS (1995).

4. INTERNATIONAL CHAMBER OF COMMERCE, PUB. NO. 458, UNIFORM RULES FOR DEMAND GUARANTEES (1992).

5. INTERNATIONAL CHAMBER OF COMMERCE, PUB. NO. 524, ICC UNIFORM RULES FOR CONTRACT BONDS (1993).

6. UNIDROIT Convention on International Factoring, *done* May 28, 1988, 27 I.L.M. 943.

7. UNIDROIT Convention on International Financial Leasing, *done* May 28, 1988, 27 I.L.M. 931.

8. United Nations Convention on International Bills of Exchange and Interna-

ters of Guarantee and Standby Credits.

The present paper is devoted to abstract payment undertakings by banks in international trade: undertakings which are given to support a trading transaction between the bank's customer and the customer's counterparty but which are considered in law distinct from and largely independent of that transaction. Specifically I want to focus on two payment instruments, the documentary credit and the demand guarantee/standby credit, in the context of the 1993 UCP revision, the URDG and, more briefly, the UNCITRAL convention. I do not propose to say anything about suretyship guarantees. Nor will I discuss the so-called "direct pay" standby, since, being a simple-minded man, I do not understand how a credit can at one and the same time be a direct pay credit and standby!

### *B. The Peculiar Nature of Abstract Payment Undertakings*

Payment undertakings of the kind I shall be examining do not fall within ordinary contract principles. They do not involve offer and acceptance (being considered binding as from the time of issue unless and until rejected by the beneficiary); they do not depend on consideration or reliance by the promisee; they are not governed by any special formal requirements (such as a deed); and they fit neither the definition of a bilateral contract nor that of a unilateral contract. They are best regarded as mercantile specialties, undertakings which, by the usage of merchants, have effect by virtue of their issue without any additional requirements. Leading American scholars treat such undertakings as engagements rather than as contractual promises in the strict sense.<sup>9</sup> English writers tend to regard them as contractual in character since the grounds for avoiding them and the remedies for their breach are determined by ordinary contract principles. We need not be overly concerned about the difference in approach, which (once one accepts the binding force of such undertakings) will in most cases be of little practical consequence.

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tional Promissory Notes, G.A. Res. 165, U.N. GAOR, 43d Sess., Supp. No. 41, at 280, U.N. Doc. A/43/41 (1989).

9. See, e.g., JOHN F. DOLAN, LAW OF LETTERS OF CREDIT ¶ 3.03 (2d ed. 1991).

### *C. Characteristics of Abstract Payment Undertakings*

Documentary credits and demand guarantees have several characteristics in common. Both are abstract payment undertakings, so that they are not required to conform to the ordinary conditions for a valid and binding contract. Both are autonomous in character, so that in principle the bank's duty is to pay against conforming documents without regard to whether, in the case of documentary credits, there has been proper performance of the underlying contract by the beneficiary or, in the case of demand guarantees, there has been a breach of the underlying contract. Both are documentary in character, so that the obligation is triggered solely by presentation of documents within the time and on the terms specified in the undertaking without regard to external facts or events. In both cases the bank fulfills its duty by paying against documents which appear, on reasonable examination, to conform to the credit. This occurs even if it transpires that without the bank's knowledge one or more of the documents has been forged or fraudulently altered or contains false data. But in other respects there are crucially important differences between documentary credits and demand guarantees to which I shall advert a little later.

### *D. The Nature and Scope of the UCP and the URDG*

For those not familiar with the UCP and the URDG, I should explain that these are in substance model rules of banking custom and practice which largely, though not entirely, represent and codify existing custom and practice and are given effect by incorporation into all relevant contracts: between the principal (or applicant for the credit) and the issuing bank; between the issuing bank and the beneficiary; between the confirming bank or authorised negotiating bank and the beneficiary; and between the different banks themselves. The ICC, though an international organisation, is not a law-making body but an organisational representation of world business and finance. Its rules do not have the force of law but depend (as the rules themselves expressly provide) on the parties to contracts incorporating them as terms of their contracts. It follows that the UCP and the URDG are necessarily confined to matters capable of being dealt with by contract. So they cannot deal with such matters as the effect of fraud on a

beneficiary's right to payment, the grant of injunctive relief to restrain presentation of documents or payment, or the relations between a contracting party and third parties. Moreover, however detailed the rules, there remain key issues which have had to be worked out by the courts and to which I will turn shortly.

#### *E. Status of the UCP*

The current version of the UCP is that published in 1993 and known as UCP 500.<sup>10</sup> This replaced the 1983 version (UCP 400).<sup>11</sup> Since the UCP take effect by contractual incorporation, they may be amended or excluded as the parties wish. Over time the UCP have gained universal acceptance in international trade. So pervasive is their use that the revised article 5 of the Uniform Commercial Code specifically defers to them, providing that it is not to apply to the extent that the parties expressly adopt the UCP.<sup>12</sup>

#### *F. What the New UCP Can Do*

The new UCP clarify various matters that were doubtful under UCP 400, e.g., as to what is meant by negotiation<sup>13</sup> and whether a bank is obliged to agree to a transfer of a transferable credit. They change what was previously a presumption of revocability into a presumption of irrevocability,<sup>14</sup> in line with the general desire and understanding of the market. They introduce the international standard banking practice as the yardstick against which to measure compliance of the documents with the terms of the credit. They nullify (or at any rate purport to nullify) non-documentary conditions. They introduce the principle of one bite of the cherry, requiring a bank that rejects documents to state *all* discrepancies at the time of rejection. And they introduce changes designed to accommodate developments in transport modes and documents and electronic means of communication.

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10. *See supra* note 2.

11. INTERNATIONAL CHAMBER OF COMMERCE, PUB. NO. 400, UNIFORM CUSTOMS AND PRACTICE FOR DOCUMENTARY CREDITS (1983).

12. U.C.C. art. 5 (1993).

13. U.C.P. art. 10(b)(ii) (1993).

14. *Id.* art. 6(a).

### G. *What the New UCP Cannot Do*

It is important to bear in mind that the UCP, like any other rules promulgated by the ICC, are primarily intended to guide banking practice relating to documentary credits, not to provide a comprehensive treatment of legal rights and duties. In line with this, the UCP provide no more than a very generalised statement as to the compliance standard; and they do not prescribe the exceptions to the principle of the autonomy of the credit, leaving these and related matters to be dealt with by decisions of the courts.

## II. DOCUMENTARY CREDITS

In this section I shall confine myself to three issues: the standard of compliance, the treatment of non-documentary conditions, and the circumstances in which the courts will depart from the principle of autonomy of the credit.

### A. *The Standard of Compliance*

A crucial question, which has long dogged bankers and their legal advisors, is how strictly the documents must conform to the terms of the credit. Is the standard a strict standard, so that even the most minor deviations entitle the bank to refuse payment, and, indeed, oblige it to do so unless otherwise authorised by the applicant for the credit? Or is it a substantial compliance standard, under which deviations that the bank has no reason to believe are of commercial significance are ignored? Or does the law adopt a bifurcated approach, under which the bank is entitled to invoke a strict standard of compliance against the beneficiary but is entitled to the benefit of a more relaxed standard vis-a-vis its customer in choosing to pay despite minor deviations?

Most courts appear to adopt a strict standard of compliance. But this is not the same as exact compliance. In particular, obvious typographical errors will be disregarded. This principle is, however, easier to state than to apply. Take the Hong Kong case *Hing Yip Hing Fat Co. Ltd. v. Daiwa Bank Ltd.*,<sup>15</sup> in which the name "Cheergoal Industries Limited" was incorrectly reproduced as "Cheergoal Industrial Limited." The

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15. [1991] 2 H.K.L.R. 35 (High Court).

bank paid despite the error and Judge Kaplan held that it was entitled to do so, the error being purely typographical.<sup>16</sup> But is it reasonable to suppose that the bank would have been within its rights in rejecting the documents, for how could it be sure that there was not a separate company Cheergoal Industrial Limited? This suggests two conclusions. First, if the error proves to be typographical, the bank can retrospectively justify its acceptance of the documents even if at the time it simply failed to notice the discrepancy. Second, there is no necessary correlation between a right to pay and a duty to pay; here the bank had a choice whether to pay or to refuse payment.

### 1. International banking practice as a compliance standard

The advantage of a strict rule is that it is reasonably clear and absolves the bank from making judgmental decisions. But at the international level there are straws in the wind indicating that the rule of strict compliance may come under pressure.

In the first place, the UCP contain a new provision, in article 13(a), which may have unintended consequences. It states in part:

Compliance of the stipulated documents on their face with the terms and conditions of the Credit, shall be determined by international standard banking practice as determined by these Articles.<sup>17</sup>

A similar provision is to be found in article 13(2) of the 1995 UNCITRAL Convention on Independent Guarantees and Standby Letters of Credit. Now one can see the good sense of an international standard. After all, the whole purpose of the UCP is to harmonise banking practice and to prescribe a uniform set of rules. The adoption of different compliance standards in different jurisdictions tends to undermine the very uniformity the rules are designed to promote. But this problem is inherent in uniform rules, whether they are rules incorporated by contract or rules prescribed by an international convention. Except where jurisdiction to give definitive rulings is conferred on a supranational body—as in the case of the Euro-

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16. *Id.* at 45.

17. U.C.P. art. 13(a) (1993).

pean Court of Justice as regards the interpretation of the 1968 Brussels Convention on jurisdiction and enforcement of judgments<sup>18</sup> and the 1980 Rome Convention on the law applicable to contractual obligations<sup>19</sup>—the risk of divergence among national courts is inevitable. The risk is exacerbated by the difficulty of discovering rulings in other jurisdictions in the absence of a truly international system of law-reporting. In the case of documentary credits the ICC's Banking Commission renders valuable service through its interpretative opinions, but these, though persuasive, are not binding on courts.

Although an appeal to an international standard is understandable, what exactly does this mean and where is it to be found? Article 13(a) does not prescribe an international standard in the abstract but "international banking practice as reflected in these Rules."<sup>20</sup> The same article requires banks to examine documents with reasonable care.<sup>21</sup> Certain tolerances are expressly provided by article 39. Thus the words "about," "approximately," or "circa" or similar words used in connection with the amount of the credit or the quantity or unit price stated in the credit are to be construed as allowing a difference not exceeding 10% more or 10% less;<sup>22</sup> and a tolerance of 5% more or 5% less in the quantity of goods is permissible unless the credit stipulates the quantity must not be exceeded or reduced or the extra would take the drawings above the amount of the credit.<sup>23</sup> But this tells us nothing about the standard of compliance in relation to other matters. Indeed, on the principle *expressio unius alterius*, article 39 might suggest that other tolerances are not permitted.

Article 13(a) is evidently intended to deter courts from being on the one hand too ritualistic in treating documents as non-conforming where the defects are trivial and obvious, and on the other from being too liberal by invoking considerations such as good faith or lack of commercial significance of the

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18. Protocol of 3 June 1971 on the Interpretation by the Court of Justice of the Convention of 27 September 1968 on Jurisdiction and Enforcement of Judgments in Civil and Commercial Matters, 1978 O.J. (L 304) 97.

19. Convention on the Law Applicable to Contractual Obligations, *opened for signature* June 19, 1980, O.J. (L 266) 1.

20. U.C.P. art. 13(a) (1993) (emphasis added).

21. *Id.*

22. *Id.* art. 39(a).

23. *Id.* art. 39(b).

discrepancy. The difficulty is to know not only where to draw the line but also where international standard banking practice is to be found. It is always easier to identify local practices than international ones, even in relation to international transactions. Just as the law of international trade is still not truly international but consists of different national laws governing international trading transactions, so also banking practice will not necessarily be the same around the globe. What is done in London and New York is not necessarily what is done in Zurich or Singapore. This in turn leads to the question how far the standard is to be influenced by the size and degree of expertise reasonably to be expected of a bank located in the country of the issuing or confirming bank. Is this relevant at all? Or are all banks around the world to be held to the standards of care, speed and efficiency expected of major banks in the world's financial centres?

All this suggests that article 13(a) is unlikely to do more than reinforce the view of national courts that the position they already adopt—whatever it may be—is the right one.

## 2. The concept of good faith

There is another, and potentially more serious, challenge to the principle of strict compliance, namely the concept of good faith. A general concept of good faith has long been a tenet of the civil law and has been spreading rapidly to other legal families. It is featured, for example, in the American Uniform Commercial Code,<sup>24</sup> the Vienna Sales Convention,<sup>25</sup> the EC Directives on self-employed commercial agents<sup>26</sup> and unfair terms in consumer contracts,<sup>27</sup> the UNCITRAL Convention,<sup>28</sup> and the UNIDROIT Conventions on International Factoring<sup>29</sup> and International Financial Leasing,<sup>30</sup> as well as in

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24. U.C.C. § 1-203 (1994).

25. See United Nations Convention on Contracts for the International Sale of Goods, art. 7(1), U.N. Doc. A/CONF.97/19 (1980). Article 7(1) is a formulation that is becoming a standard provision in international trade conventions. See, for example, the conventions referred to in notes 28-30 *infra*.

26. Council Directive 86/653, arts. 3(1), 4(1), 1986 O.J. (L 382) 17.

27. Council Directive 93/13, art. 3(1), 1993 O.J. (L 95) 29, 31.

28. Arts. 5, 19; see *supra* p. 2 and *infra* p. 18.

29. UNIDROIT Convention on International Factoring, *supra* note 6, art. 4(1), 27 I.L.M. at 943.

30. UNIDROIT Convention on International Financial Leasing, *supra* note 7,

the UNIDROIT Principles for International Commercial Contracts<sup>31</sup> and the separate Principles of European Contract Law<sup>32</sup> issued by the Commission on European Contract Law. Only two years ago an English court, applying Swiss law, held that it would be contrary to the principles of good faith to allow a bank to rely on discrepancies to refuse payment under a letter of credit when it had received the proceeds of a back-to-back letter of credit.<sup>33</sup>

English law does not as yet possess any general principle of good faith in contracts. Its courts, conscious of London's position as a world financial centre, are wary of such open-textured concepts and the degree of unpredictability perceived as likely to result from their introduction.<sup>34</sup> It is not clear how long this approach will be maintained. Once the courts have become accustomed to handling good faith in the context of the EC Directive on unfair terms in consumer contracts, they may find that they can live with it after all. Even so, it is not clear what implications this would have for the bank's right to reject non-conforming documents tendered under a letter of credit. Where, in contrast to the Swiss bank case, the bank has no interest of its own in the outcome of the presentation, is its own good faith to be determined by whether a rejection of the documents by its customer would be in good faith, or is some other criterion to be applied? And how far should the requirement of good faith incline the court towards adopting a substantial compliance standard?

As a further example of the difficulties, consider article 19(1) of the UNCITRAL Convention.<sup>35</sup> This states that where it is manifest and clear that any document is not genuine or

art. 6(1), 27 I.L.M. at 931.

31. INTERNATIONAL INSTITUTE FOR THE UNIFICATION OF PRIVATE LAW, PRINCIPLES OF INTERNATIONAL COMMERCIAL CONTRACTS art. 1.7(1) (1994).

32. COMMISSION ON EUROPEAN CONTRACT LAW, THE PRINCIPLES OF EUROPEAN CONTRACT LAW art. 1.106(1) (Ole Lando & Hugh Beale eds., 1995).

33. *Hannesman Handel, A.G. v. Kaunlaren Shipping Corp.*, [1993] 1 Lloyd's Rep. 91. The case was wholly unusual, for the bank was aware of the falsity of the documents but relied on them to obtain payment of the assigned proceeds. The court's refusal to allow the bank to invoke the non-conformity of the documents is therefore understandable. It is interesting to speculate whether the outcome would have been different if the letter of credit had been governed by English law.

34. *But see* Steyn J. (now Lord Steyn), *The Role of Good Faith and Fair Dealing in Contract Law: A Hair-Shirt Philosophy?*, 1991 DENNING L.J. 131.

35. Art. 19(1); *see supra* p. 2 and *infra* p. 18.

has been falsified, no payment is due on the basis asserted or judging by the type and purpose of the undertaking the demand has no conceivable basis, then the guarantor/issuer, *acting in good faith*, has a right, as against the beneficiary, to withhold payment. What does good faith mean in this context? If it is clear that the payment is not due, how can the bank be acting in bad faith if it refuses payment?

*B. The Treatment of Non-Documentary Conditions*

It is a fundamental rule of the UCP that banks only deal with documents, not with goods or services or with external facts, and that only documentary conditions for payment can properly be included in the credit.<sup>36</sup> Unfortunately, banks and their customers all too often overlook this basic principle, so that credits are issued which subject payment to external conditions, such as the quality of the goods or the mode or time of shipment. Literally construed, these conditions would require the bank to satisfy itself that the goods were in fact of proper quality and were in fact shipped in the designated manner or by the specified time, matters which the bank is not well-equipped to investigate and could not be expected to investigate within the short time allowed for a decision whether to accept or reject the documents.

In preparing the 1993 revision of the UCP, the Banking Commission of the ICC decided that it was high time to inject a sense of order and discipline into the market-place. This it has done with a vengeance in its new article 13(c), which states in peremptory terms that:

If a Credit contains without stating the document(s) to be presented in compliance therewith, banks will deem such conditions not stated and will disregard them.<sup>37</sup>

Though the objective is laudable, I suspect that the cure may prove worse than the disease. Until now courts have been able to construe conditions in letters of credit as intended to be

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36. Ironically, the UCP infringe upon their own principle in art. 43, which provides for refusal of documents presented after the expiry of a given period from the date of shipment! Presumably what is meant is the date shown on the bill of lading or other shipping document. See U.C.P. art. 43 (1993).

37. *Id.* art. 13(c).

documentary in character, so that a requirement as to some external fact has been treated as a requirement to produce satisfactory documentary evidence of that fact. This sensible approach now seems barred, for if the documents are not *stated* article 13(c) comes into play and the condition is required to be ignored. This poses acute problems. First, it involves the bank treating as nugatory a condition of its own credit which itself has inserted into the letter of credit, albeit at the request of its customer. Second, it raises a question whether the bank owes its customer a duty to warn that the stipulated condition will be of no effect. Third, since the parties are free to exclude or modify any provision of the UCP, how is one to determine whether the inclusion of a non-documentary condition is to be void under article 13(c) or a binding condition intended to operate outside the UCP altogether?

### *C. The Autonomy Principle and its Exceptions*

A fundamental principle of documentary credits law is the autonomy of the credit, that is, its independence both from the underlying trade transaction between the applicant for the credit and the beneficiary, and from the relationship between the former and the issuing bank. This concept, enshrined in articles 3 and 4 of the UCP,<sup>38</sup> is widely recognised and applied by courts around the world. So, in general, it is not a defence to a claim on the credit that the beneficiary appears to have committed a breach of the underlying contract, that the contract is unenforceable (e.g., for illegality), or that the applicant for the credit has failed to put funds in the issuing bank. This is scarcely surprising, for the typical letter of credit transaction sets up a series of engagements involving different parties, and it would be strange if a breach of contract between, for example, the beneficiary and the applicant for the credit, were to constitute a defence to a claim under an entirely separate engagement between issuing bank and beneficiary, an engagement to which the applicant for the credit is not a party.

The extension of the UCP to cover credits issued by a bank for its own account<sup>39</sup>—namely, to discharge an obligation in-

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38. *Id.* arts. 3-4 (1993).

39. *Id.* art. 2 (1993).

curred to the beneficiary by the bank itself—raises the question whether in this two-party situation the letter of credit still remains independent of the underlying transaction. Here, the parties to the two engagements are identical, so that the doctrinal arguments for treating one engagement as independent of the other are less compelling. Nevertheless, the general principle must still apply. There is nothing particularly novel in an arrangement by which the payment obligation under a commercial contract is tapped off into a separate contract insulated from the main agreement. The typical case is the bill of exchange given in payment for goods or services and considered to generate a distinct contract between holder, drawer, and acceptor.

What is distinctive about the letter of credit is the degree of insulation which is afforded as a result of its abstract character. Except as against a holder in due course, a party who would otherwise be liable on a bill of exchange can plead a total or partial failure of the consideration for which the bill was given. So a buyer of goods sued on a bill, who has exercised a right to reject the goods for non-conformity with the sale contract, can plead that the consideration for the bill has wholly failed. But, as we have seen, a documentary credit is a form of abstract payment undertaking which is not required to be supported by consideration in the first place. It follows that the question of failure of consideration cannot arise. This must apply just as much to a credit issued for the issuer's own account as to one issued for the account of a third party, for the payment undertaking is just as abstract in the former case as in the latter.

All jurisdictions admit of certain exceptions to the autonomy principle. In particular, fraud on the part of the beneficiary or his agent in relation to documents tendered under the credit disentitles the beneficiary to payment. In England, other defences have been admitted, such as illegality affecting the letter of credit transaction, set-off between beneficiary and issuing bank, and rescission of the letter of credit transaction on the ground that it was induced by misrepresentation. In the United States it is not necessary that the fraud should relate to the documents; fraud in the underlying transaction suffices. In many jurisdictions the ambit of the exceptions to the autonomy principle has been a matter of considerable debate and controversy. Is there conduct short of fraud which nevertheless

makes a claim on the credit abusive?<sup>40</sup> Is fraud on the part of a third party for whose acts the beneficiary is not legally responsible a defence? Suppose that such fraud consists in the forgery of a document presented under the credit. Can the beneficiary say that he is innocent of the fraud and entitled to payment, or can the bank plead that while it is *entitled* to pay against a forged document which appears on its face to be genuine it is not *obliged* to do so, since a forged document is not a document that conforms to the credit?<sup>41</sup> What is meant by fraud in the underlying transaction (for example, does it cover fraud not reflected in the documents at all, such as a fraudulent misrepresentation by the seller inducing the buyer to enter into the contract of sale) and how far is this a defence? There is a divergence of views not only between different law systems, but even within the same law system both on what constitutes a defence to a claim on a credit and on the approach to be taken by the court on an application for interim injunctive relief. It is therefore helpful that the UNCITRAL Convention on Independent Guarantees and Standby Letters of Credit has addressed these issues.<sup>42</sup> Indeed, it is this part of the Convention which is one of the most likely to be of practical utility.<sup>43</sup>

### III. DEMAND GUARANTEES AND STANDBY CREDITS

#### A. *Demand Guarantees and Documentary Credits: Comparisons and Contrasts*

I now turn to demand guarantees. As noted earlier, the documentary credit is designed to ensure the discharge of a

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40. This question has surfaced with particular force in relation to claims on demand guarantees.

41. In the English House of Lords decision in *United City Merchants (Inv.) Ltd. v. Royal Bank of Canada (The American Accord)*, [1983] 1 App. Cas. 168, Lord Diplock, in an *obiter dictum*, opined that even forgery of a document did not necessarily disentitle the innocent beneficiary to payment. In my view, this confuses two entirely distinct defences, the fraud defence (which is available only against a beneficiary who or whose agent has been involved in the fraud) and the logically anterior defence that the document, if not genuine, does not conform to the credit. For a more extended criticism of Lord Diplock's speech, see Roy Goode, *Abstract Payment Undertakings*, in *ESSAYS FOR PATRICK ATIYAH* 209, 229 (Peter Cane & Jane Stapleton eds., 1991).

42. Arts. 19-20.

43. See *infra* p. 19.

payment obligation. By contrast, the demand guarantee is used almost exclusively to secure the performance of a non-monetary obligation—typically the execution of construction works or the delivery of conforming goods under a contract of sale<sup>44</sup>—and is conceived as a default mechanism. It is the principal (the equivalent of the applicant for the credit in a documentary credit transaction) who is primarily responsible for the performance to which the demand guarantee relates, and the agreement between principal and beneficiary requires, expressly or by implication, that the beneficiary resort to the bank only if the principal defaults. So whereas a bank pays a documentary credit only if things go right, in the case of a demand guarantee it is intended that the bank will be called upon to pay only if things go wrong. But the agreement as to the default nature of the demand guarantee is internal to the principal-beneficiary relationship and does not concern the bank, whose duty is to pay against a written demand and such other documents, if any, as the guarantee may specify. Thus the demand guarantee shares with the documentary credit the characteristic that it is an abstract payment undertaking, insulated from the underlying trade transaction, but differs from the documentary credit in that it is improper for the beneficiary to call the guarantee if he does not honestly believe that the principal has committed a breach of the underlying contract. Accordingly, the problem of unfair or abusive calls is peculiar to demand guarantees and cannot arise in relation to documentary credits, where it is agreed from the outset that the bank, not the principal, is to be the first port of call for payment.

Three further differences between documentary credits and demand guarantees may be noted. First, the former usually involve the presentation of a substantial volume of documents, and more often than not these fail to conform to the credit on first presentation, whereas the documentation required for a claim on a demand guarantee is skeletal in the extreme, entailing in most cases presentation of no more than the written demand itself. Second, the making of “extend or pay” demands is a particular feature of demand guarantee

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44. This is one of the many respects in which the demand guarantee differs from the standby credit, which is frequently used to underpin payment obligations.

practice for which the URDG (though not the UNCITRAL Convention) made special provision. Third, in a four-party demand guarantee transaction the position of the parties to the counter-guarantee has to be covered.

I will look at two major issues arising under the URDG, the formalities for a valid demand and the treatment of extend or pay demands. But first I should like to make a brief comment about the position of standby letters of credit.

### *B. Standby Letters of Credit*

Standby letters of credit were brought within the UCP for the first time in the 1983 revision, primarily to alleviate the concerns of American banks, most of whom were prohibited from issuing suretyship guarantees and were anxious to send a signal to American courts that standby credits were to be equated with autonomous documentary credits, not with suretyship guarantees. Are standby credits also within URDG?

The treatment of standby credits in relation to URDG has an interesting history. A late draft of the URDG actually contained a provision declaring that the URDG were inapplicable to standby credits. I pointed out that such a provision would set upon the courts an impossible task, for from a legal viewpoint demand guarantees and standby credits are indistinguishable, and the latter clearly falls within the definition of a demand guarantee in article 2. Accordingly, the first draft, prepared by the Drafting Group established to finalise a text and resolve the impasse reached in the original Working Party, made explicit reference to standby credits in article 2. However, bankers were understandably keen to keep the UCP as the applicable set of rules, since it was more detailed and the courts were familiar with the concept. In the end a compromise was reached. The draft was revised to omit specific reference to standby credits in the text of the rules, whilst the introduction made it clear that standby credits were technically within the rules but that banks were advised to continue using the UCP. This solution was approved by the two Commissions involved in the preparation of the rules, the Banking Commission and the Commission on International Commercial Practice.

It has to be said that the treatment of standby credits is not entirely satisfactory. On the one hand, the UCP are much more detailed and therefore deal with matters that are not at

present covered by the URDG, including the issue of a credit for the insurer's own account and the confirmation of a credit. On the other hand, the UCP are conceptually inappropriate for standby credits,<sup>45</sup> since almost all of the provisions are designed for situations in which the obligation under the underlying trade transaction is a payment obligation and the issuing bank is the first port of call for payment. The UNCITRAL Convention<sup>46</sup> produces the converse situation in which, as a last minute addition to the text, parties to a commercial credit can opt into the Convention, despite the fact that all its other provisions are geared to instruments that cannot properly be called except in the event of the principal's default.

### *C. Formalities for a Valid Demand*

Article 20 of the URDG contains a very distinctive rule requiring the beneficiary to present with his demand a statement that the principal is in breach, and the respect in which he is in breach.<sup>47</sup> This requirement applies even if on its face the only document specified is the demand itself, unless the guarantee expressly excludes article 20. The purpose of article 20 is to impose some constraint on unfair calling of the guarantee without undermining its efficacy as a swift remedy in the event of a perceived default. The constraint is somewhat limited in that the statement of breach is required only from the beneficiary himself, not from an independent third party. Even so, a beneficiary who has little compunction in making a written demand where there has been no breach may feel somewhat inhibited from doing so where he has to commit himself to a false statement of breach. To ensure that article 20 is not overlooked there is much to be said for setting out its terms in the text of the guarantee, as is done with the ICC Model Forms for Issuing Demand Guarantees.<sup>48</sup> A demand by

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45. In many cases, the UCP is impossible to apply. For example, the default rule in the UCP which holds that documents must be presented within 21 days of the date of shipment (U.C.P. art. 43(a) (1993)) is a completely meaningless requirement when applied to demand guarantees.

46. See *infra* p. 18.

47. The phrase, "the respect in which" (as opposed to "respects"), is intended to require only a general statement of the nature of the breach (e.g., that the principal has been guilty of delay, defective workmanship, and a shortfall in delivery of goods), not a detailed specification. See ROY GOODE, GUIDE TO THE ICC UNIFORM RULES FOR DEMAND GUARANTEES 93-94 (1992).

48. INTERNATIONAL CHAMBER OF COMMERCE, PUB. NO. 503(E), ICC MODEL

the guarantor under the counter-guarantee given by the instructing party (the principal's bank) must specify not only that the guarantor has itself received a demand from the beneficiary but that the demand conforms to article 20.

*D. "Extend or Pay" Demands*

It is not uncommon for a beneficiary to present an "extend or pay" demand requiring the period of the guarantee to be extended, failing which payment is to be made forthwith. Demands of this kind are not necessarily improper, for there may have been, or the beneficiary may honestly though mistakenly believe that there has been, a breach of the underlying contract but may be willing to allow time for this to be rectified if the guarantee is extended. The first point to note is that if the demand is to be triggered automatically because of non-extension of the guarantee it must be a demand which conforms to the rules, in particular to the requirements of article 20. Upon receiving the extend or pay demand the guarantor must, without delay, inform the party who gave him his instructions<sup>49</sup> and must suspend payment for as long as is reasonable to permit the principal and the beneficiary to reach agreement on the granting of the extension and to enable the principal to arrange for such extension to be issued. There are various possible outcomes. The principal may agree to the extension, wholly or in part, in which case it takes effect when issued by the guarantor. The guarantor is not obliged to issue it, and even if he has agreed with the principal to do so, that is not an agreement of which the beneficiary can take advantage. Alternatively, the principal may refuse the extension, in which case the guarantor must pay in the absence of fraud by the beneficiary or some other vitiating factor. A third possibility is that the beneficiary withdraws the demand, which thereupon lapses. Finally, negotiations may still be in progress when a reasonable time has elapsed, in which event the guarantor must pay, even if by then the guarantee has expired.<sup>50</sup>

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FORMS FOR ISSUING DEMAND GUARANTEES (1994).

49. Thus, in the case of a direct guarantee, the guarantor would inform the principal, and in the case of an indirect guarantee, the guarantor would inform the instructing party.

50. This is because the rules require only that the documents be *presented* before expiry (U.C.P. arts. 19, 22 (1993)). The time when payment falls due after

*E. The UNCITRAL Convention*

In the light of the URDG, it is at first sight somewhat surprising that UNCITRAL has invested such time and effort in producing its 1995 Convention on Independent Guarantees and Standby Letters of Credit covering much of the same ground. The reason for this is historical. Soon after UNCITRAL first began to look at demand guarantees, the ICC began its project to formulate a set of demand rules designed to be more accommodating of prevailing practice than the 1978 rules.<sup>51</sup> Thereupon, UNCITRAL agreed to halt further work and defer to the ICC project. Unfortunately, this proceeded much more slowly than had been expected, and when after the lapse of several years it showed no signs of reaching finality. UNCITRAL understandably decided to proceed with its own proposals for a convention or uniform law. By the time the URDG had got back on track, the UNCITRAL project was considered too far advanced to be abandoned. Moreover, being a work designed to lead either to a Convention or to a uniform law capable of adoption in national legislation it was able to deal with matters that could not properly be the subject of contractually incorporated rules, notably the effect of fraud and the grant of interim injunctive relief. In its treatment of contractual relations between the parties, the Convention follows the URDG fairly closely in scope and effect, though the drafting is somewhat different and the draft Convention does not contain any equivalent of article 20, nor does it deal with extend or pay demands.

Given that the contractual aspects of the Convention can be excluded by agreement of the parties, it is unlikely that in relation to these aspects the Convention will ever play a significant role, for in the great majority of cases the parties will incorporate either the URDG or the UCP, and in either case the effect will be to displace those provisions of the Convention dealing with contractual rights and duties. It is in the field of defences to a payment claim and the ground for interim injunctive relief that the influence of the Convention is most likely to be felt. It will be interesting to see how effective it will be in

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exhaustion of the article 26 procedure is irrelevant.

51. INTERNATIONAL CHAMBER OF COMMERCE, PUB. NO. 328, UNIFORM RULES FOR CONTRACT GUARANTEES (1978).

reducing the divergences of approach between national courts.

#### IV. CONCLUSION

This paper has examined some of the more important concepts underlying the UCP, the URDG and the UNCITRAL Convention. What significance do these instruments have for the general development of transnational commercial law? I believe that they provide a further demonstration of the enormous influence of trade practice and the needs of legitimate business on the development of commercial law. So strong is this influence that sooner or later evolving business practice will always break free from the shackles of doctrine and jurisprudence and demand acceptance by the courts or the legislature. Typically, the process of harmonisation begins not with any international instrument but with conscious or unconscious judicial parallelism as the courts in each country respond to the needs of that country's business community. So by the time work is begun on uniform rules a considerable measure of international consensus on law and practice will already have developed, despite major divergences in the general contract law of the legal systems involved. The extent to which these divergences can be reconciled or cast aside is a striking testimony to the pressure for a new *lex mercatoria* which, as in the Middle Ages, will transcend national boundaries and bring different systems of law into harmony through the usages of trade.